MEXICO ECONOMIC CRISIS

Y 4. IN 8/16: M 57/3

Mexico Economic Crisis, 104-1 Heari...

HEARING

BEFORE THE

COMMITTEE ON INTERNATIONAL RELATIONS HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

FEBRUARY 1, 1995

Printed for the use of the Committee on International Relations

MAY 24 1995

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MEXICO ECONOMIC CRISIS

WEDNESDAY, FEBRUARY 1, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERNATIONAL RELATIONS,
Washington, DC.

The committee met, pursuant to call, at 10:10 a.m. in room 2172, Rayburn House Office Building, Hon. Benjamin A. Gilman (chairman of the committee) presiding.

Chairman GILMAN. The committee will come to order.

I am pleased to welcome our panel of expert witnesses this morning. They had to do some late night editing, I am sure, of their prepared statements because of the President's unexpected announcement yesterday of a revised plan to assist Mexico. Their flexibility and perseverance is certainly very much appreciated by the committee.

I am, however, extremely disappointed that the Secretaries of State and Treasury declined to appear before our committee this morning. It seems that they would have welcomed this opportunity to explain the new plan to the Congress after briefing the press yesterday, and should be certainly fully aware of all of the implications of the new plan.

I hope today's hearing will mark the beginning and not the end of the dialogue between the executive and legislative branches on the future of our economic relations with Mexico.

Congressional authorization may not be required for the new plan, but the administration still must explain to the American people and to the Congress why billions of U.S. taxpayer dollars should be used to assist Mexico in its current financial crisis.

In utilizing our Treasury Department fund to protect the peso, we need to be certain that it retains enough resources to protect the dollar in any future monetary crisis.

We also need to know that Mexico is moving to correct its own policies and reform its institutions in order to prevent a future repetition of this crisis.

When he appeared before the Banking Committee on January 25, Secretary of State Christopher indicated that Mexico's capacity to cooperate with us on such issues as narcotics trafficking, money laundering, and environmental issues could be strained unless the loan guarantee plan were adopted.

I would invite the Secretary to come before our committee in the near future to explain how these worthy objectives can be achieved with the adoption of the new plan.

While I don't question the President's authority to implement this financial rescue package, we do need to get additional details

of how it is going to be implemented. We look forward to hearing the comments and views of today's panelists on all of the issues surrounding the new plan.

All of our witnesses before us today have written extensively on the financial issue in Mexico.

Before recognizing our first witness, I would remind my colleagues that I will recognize those members present in order of seniority when our meeting begins, and thereafter, will recognize members based on their order of arrival, and we will alternate our questioning between majority and minority.

Do any other members have any opening statements?

[The prepared statement of Chairman Gilman appears in the appendix.]

Mr. HAMILTON. Mr. Chairman.

Chairman GILMAN. Mr. Hamilton.

Mr. HAMILTON. Mr. Chairman, I want to join you in welcoming our witnesses today, and I fully understand that they have had an extremely tough task in the last few hours. I am trying to absorb this myself, and while you are much better able to do so than I, it is not easy to testify on a proposal of this significance on such short notice.

I think that the President struck out on his own yesterday in an effort to help deal with the Mexican crisis, and if he is right about the consequences of the Mexican economic collapse, and so far as I know he is, then he probably deserves admiration and support for his action.

Mr. Chairman, I too share your regret that the administration chose not to appear today, but I think I understand their reluctance to do so. There are very few things that are worse for an administration to do than to testify before they are ready. And there are large parts of this proposal, I think, on which the details still have to be worked out. So I look forward to their testimony in the near future.

The whole economic crisis and our approach to it was completely transformed yesterday, and I am informed that much of the details have not yet been finalized. But I am pleased to hear you say that we will be inviting them up to testify on this proposal within the next several days, and I think that will be important. But these witnesses before us will give us a good start. Thank you.

Chairman GILMAN. Thank you, Mr. Hamilton. Mr. Roth.

Mr. ROTH. Thank you, Mr. Chairman.

Mr. Chairman and members, yesterday the President acted decisively to cut his legislative losses on this issue. Some in Congress may be relieved, but I am not. I am concerned about the larger question: What is the risk to the American taxpayer under this plan?

Our panel here this morning, is a very able panel, and hope that they will give us some insight into that.

The administration claims that Mexico is simply facing a short-term liquidity problem, but every economist I have talked to says that in reality Mexico has serious long-term problems. While some may believe that there may be no other choice but to help Mexico refinance its immediate debts, that just postpones the day of reckoning, in my opinion.

So I would like to hear from our witnesses how we are going to protect our taxpayers from losses, not just next week, but over the long term. Can we really expect Mexico to fix the underlying problems in its economy, or has our President locked us in? And will we be dragged deeper and deeper into Mexico's economic difficulties? After all, we are in for $40 billion and then $60 billion and so on. When is enough enough?

I hope that our witnesses will address some of these basic questions, because if it is Mexico today, the precedent has been set, who tomorrow? And I am not surprised that the Secretaries of State and Treasury are not here this morning, because I think they are on very shaky ground on this latest initiative.

Mr. Chairman, I am delighted that you are having this hearing, because I think it is preeminently important for Congress to look at this initiative, because this is a precedent that may not be in the best interests of all of us.

Chairman GILMAN. Thank you, Mr. Roth. Mr. Burton.

Mr. BURTON. Thank you, Mr. Chairman.

Mr. Hamilton said that the Secretary of State and Secretary of Treasury may not be prepared to discuss this because it is still in its formative stages, and I would just like to say, boy, if it is in its formative stages, it shouldn't be. I mean, if they made a decision of this magnitude and they haven't got all of the details worked out, there is something wrong.

I also want to say that I am appalled, not disappointed, I am appalled that the administration didn't send somebody up here to talk to us about this. I was one of the people that the Speaker asked to work on this legislation, along with the chairman of the Banking Committee and some others. And we drafted some requirements in the area of foreign policy that we thought were reasonable.

Mexico gives directly or indirectly as much as $400 million a year to Castro's dictatorship in Cuba at a time when we have an embargo on that country. And we are now going to guarantee these loans without any guarantees that our monies are not going to be used to help prop up the Castro regime at a time when Mexican investors and business people are buying confiscated U.S. property that was confiscated by the Castro regime after the revolution took place? That just doesn't make any sense to me. There should have been some conditions.

Now, I worked with these other gentlemen to try to craft a piece of legislation that would solve this problem, and one of the other provisions that we wanted in there was a group of negotiable securities that could be deposited in American financial institutions to the tune of about $2.5 to $3 billion, which would guarantee that if we did have a loss, it would be minimal, and they do have those kinds of negotiable securities down in Mexico. But they didn't want to do it. Obviously, they didn't want to do it. They didn't want to agree with the Cuban language we wanted in there. And as a result, what did we do? We said, OK, we don't want to cause you guys any heartburn, we are going to go right ahead and circumvent the will of the U.S. people, the Congress of the United States and just give you the money anyhow—or give you the guarantee anyhow.

Let me just say that the Gold Reserve Act of 1934 authorizes the Secretary of the Treasury with the President's approval to use funds in order to take any action deemed necessary to stabilize the exchange value of the dollar. That is the purpose of that fund.

How are we stabilizing the exchange value of the dollar by using those funds to prop up the Mexican peso? I just don't understand it. That alludes me. I think that they are using these funds improperly. And these are questions that the administration should be answering, and they didn't—they chose not to come up here, not because they weren't prepared, because they have been working on this for a long time. They chose not to come up here because they didn't want to face the heat; they didn't want to have to answer these questions.

And I am also appalled that there is not more media here covering this hearing. I mean, you know, you should have a whole bunch of television cameras. We are talking about taxpayers' dollars that are guaranteeing a loan—possibly a major bailout of a government and it may just be the tip of the iceberg, as Mr. Roth just said. I mean, we may be getting into real deep water here in having to come up with another $20, $30, $40, $50 billion down the road.

Now I understand we have problems, and I worked on all of this with my colleagues in drafting this legislation. I understand the problems with the drugs coming across the border and maybe a larger influx of illegal aliens. I understand that the 150,000 illegal aliens that we have incarcerated from Mexico that ought to be going back down there.

We have looked into all of those things. But the bottom line is because the people of this country didn't want it and because the Congress of the United States wanted very stringent requirements put into the loan agreement, they chose to circumvent the Congress and just go straight on and do their will without listening to us, the Representatives of the people.

I want to say one more thing, Mr. Chairman. This declaration of support of Mexico has some very prominent people on this, including the three former Presidents, former Secretaries of State, Treasury, Secretaries of Commerce, USTR, and all of that, and I am very impressed with this list of people. Perhaps there should have been some kind of an agreement reached. But we should have been consulted and we should have put the—we should have set the parameters because we are the people that are accountable to the taxpayers of this country for spending their money.

All appropriations bills and spending bills originate in this House and this may end up being one of the biggest spending bills of all. So I would just like to say while these people are very credible people and I understand what they are saying in this declaration of support for Mexico, they are not the elected Representatives of the people. We are. And we should have been involved in the process; we should have been involved in the negotiations, we should have made absolutely sure that we had conditions in there that not only protected the American people, but carried out our foreign policy. And as chairman of the Subcommittee on the Western Hemisphere of this committee I am appalled, not only that they are not here to answer questions, but because unilaterally the executive branch took action without our approval.

Chairman GILMAN. Thank you, Mr. Burton. Mr. Menendez.

Mr. MENENDEZ. Mr. Chairman, first of all I have a statement that I would like to be included in the record and I ask unanimous consent to do so.

Chairman GILMAN. Without objection.

Mr. MENENDEZ. Mr. Chairman, first of all I want to thank you. I had written to you last week; I was seriously concerned that we were rushing to judgment here, and as fiduciaries of the Nation's taxpayers, I felt that this was an item that clearly needed to be aired so that we would know all of the terms, the conditions, as well as the risks associated for American taxpayers, as well as the fact of what were the losses already incurred by middle-class families across this country who invest their monies in mutual funds and who have pension funds that have been invested in Mexico based upon a speculative environment. And I was concerned we weren't going to have any hearings, Mr. Chairman, and I appreciate the fact that you did call a hearing. So I want to thank you.

But I will say that I think it is a travesty of the process and a trampling of our obligations and our responsibilities when we do not have the Secretary of State and we do not have the Secretary of the Treasury, both of whom gave briefings to the press but cannot be here to give briefings to the people who are responsible and who act as fiduciaries for the American taxpayers.

If it is in the process of being formed, and it is not finalized, then I would have at least liked to hear to the extent that they have formed it, and that they were able to release it to the press. I would have liked to have had as a Member of Congress the same opportunity that the press has of being informed, so that the information that I have and that I believe most members have is that which they have read through the media and some very skimp information that has come forth from the Department of the Treasury.

This is simply one of the largest bailouts that we will have ever created in the history of our country, with very serious questions, in my mind, with no opportunity to have a formal vehicle by which to express under what terms and conditions, if any, should we have considered such loans.

And I have real questions. Hopefully our panel is going to be able to help us and I appreciate them being here, but I think that what we—ultimately what has happened and with not having the Secretary of State here and with not having the Secretary of the Treasury here, is that very little of what we say will carry any weight here. In essence, their absence and these actions have basically silenced us. We can speak all day here, but their actions have silenced any of our attempts to try to make sure that we act in the best interests of the American taxpayers. We have been shut out.

I think it is a sad day for the institutional process of the Congress. I think it is a sad day for the relationships between the executive and the legislative branch. I think that to a large extent the great voice of democracy is silenced through this process.

Mr. HAMILTON. Will the gentleman yield?

Mr. MENENDEZ. I will in a moment.

The drama may be over; Mexico will get her bailout package, but I think this is not in the best interest of both the executive and

the legislative relationships, and clearly, is, I believe, is a travesty. I would have liked to have seen the Secretary of State and the Secretary of Treasury.

I will be happy to yield.

[The prepared statement of Mr. Menendez appears in the appendix.]

Mr. HAMILTON. I just wanted to add my perspective to what happened here.

I share the view that has been expressed, and I would like to see the administration here, and I think they will be here in a couple of days. We can all be critical of them for not being here this morning.

But I want to point this out. The President worked with this Congress for 2 or 3 weeks trying to get an agreement on a loan guarantee package. It was the opinion of every leader of the Congress, and most of us individually, that there simply were not the votes present for the loan guarantee. The President was faced with an emergency. He had to act. He was being told by his top advisors and people across the country that Mexico was right on the verge of default, that default could occur within a matter of hours.

That was a very tough call for the President. He couldn't get the Congress to act. That wasn't his fault. That was the fault of the Congress. And he was confronted with advice indicating the precariousness of the Mexican situation.

Now, I don't know whether his analysis was right or not with respect to how precarious that situation is in Mexico. We will see. It is not correct to say that we have not been consulted. My goodness, many of us in this room have spent 2 weeks being consulted on these matters.

Mr. MENENDEZ. Reclaiming——

Mr. HAMILTON. So I just wanted to point out what I think the situation was that the President confronted, and it was a tough one. Did he make the right call? I don't know.

Mr. MENENDEZ. Reclaiming my time a moment, let me just simply say I respect the gentleman's opinion. However, the fact of the matter is, you may have been in the process of those discussions and maybe some level of leadership was. But as someone who represents 600,000 people, someone who sits on this committee, someone who sits on the Subcommittee on the Western Hemisphere, I have clearly expressed in the past an interest on this, and many others. I can honestly say when I say the Congress, I certainly can't say that a great number of members have in fact been in any way involved other than expressing their opinions on the floor of the House. So therefore, I would stand by my comments, and I respect the ranking member's opinion.

Chairman GILMAN. I thank the gentleman for his remarks. Ms. Ros-Lehtinen.

Ms. ROS-LEHTINEN. Thank you, Mr. Chairman. I am opposed and dismayed at the United States risking scarce dollars to aid a country which is ruled by an autocratic government and which is a close ally of the last Communist dictatorship in this hemisphere, Cuba.

Without regard to the repression and the suffering of the Cuban people under the tyrannical rule of Fidel Castro, Mexico has become one of the leading investors in Cuba. Mexican investors have

put in millions of dollars in various economic sectors in Cuba, such as oil refining, tourism, and textiles. Moreover, many of these assets obtained by Mexican investors were previously owned by American investors before the revolution confiscated them. By bailing out Mexico, we are aiding and abetting these actions in Cuba, which only serve to continue to prop up the Castro regime at the time that it finds itself on its last legs.

Another point of concern for me is the import surge of Mexican goods, primarily agricultural goods and the effect of these imports on Florida agriculture. For example, many of my State's leading agricultural products have suffered substantial sales losses due to Mexican competition. Most disappointing is that the Mexican market is still closed to many agricultural products from my home State, even after a year after NAFTA passed, which was supposed to eliminate this problem. So it is a shame that these considerations were not taken in mind before risking billions of dollars to aid Mexico in a time of tight economic resources for our country.

Chairman GILMAN. I thank the gentlelady. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman. I echo the words of Mr. Menendez. Thank you for holding this hearing. I appreciate that very much, as all of us do.

I am concerned about the bailout in several ways. Mr. Greenspan has lobbied Congress relentlessly in recent days on behalf of this bailout, but today it looks as if the Federal Reserve will be raising interest rates, undercutting much of the purpose of this bailout.

As interest rates go up in this country, the peso is almost by definition weakened, the dollar is strengthened, making it harder for Mexico to pay off the $20 billion that the President has sent to Mexico, further encouraging also investors to take their money out of Mexico, investing in this, bringing it back with higher interest rates here, something that obviously contributed to this plunging of the value of the peso starting in December.

Second, this whole bailout does nothing to deal with the other causes of the Mexican financial crisis. Whether it is American banks lending more money than they should have, or whether it is the Mexican elite, taking that money and continuing to cause this ultimate downward plunge of the peso.

Third, it doesn't deal with the fundamental problems in Mexican society, the fundamental problems of a weak middle class, the fundamental problems of the increasing number of billionaires, and increasing amounts of poverty, with very much a dividing line of the haves and the have-nots in Mexican society.

As we have seen since January of 1994 with the passage of NAFTA, our trade position with Mexico has worsened. This was prior to the peso devaluation. The bottom fell out of our trade situation, our relative trade position with Mexico after the peso devaluation, but it wasn't going that well over the first 11½ months of 1994. Until we work with Mexico so that there is a real minimum wage, there are real labor protections so that unions can organize and the Mexican middle class can, in fact, prosper and grow and buy American products, we continue to court an unfortunate situation in Mexico.

Lastly, this problem falls at the feet of this one-party dictatorship in Mexico, of Salinas and Zedillo, who bought political popu-

larity to pass NAFTA and to win their elections so that they can continue this six-and-a-half decade one-party rule, the longest one-party rule since the Bolsheviks fell, in any country in the world. They bought that political popularity instead of taking responsibility in dealing slowly with the declining value of the peso.

That is what we need to know more about; that is what we need to know if we are going to deal with this whole financial crisis. That is what concerns me the most, Mr. Chairman, about this whole bailout and that is what we need to continue to discuss.

Chairman GILMAN. Thank you, Mr. Brown. I have requests of an opening statement by Mr. King, Mr. Ackerman, Mr. Sanford and Mr. Engel. I would like to urge my colleagues to please be brief so that we can have the benefit of the testimony by our experts. Mr. King.

Mr. KING. Thank you, Mr. Chairman.

Mr. Chairman, I make my remarks from the perspective of someone who was inclined to vote for a guarantee, a loan guarantee proposal. However, in saying that, I am very critical of the administration for the terrible failure of leadership they have shown in this entire regard. The reason I say that is if the President felt this was in the national security, if he had upped the stakes so much to say this was vital to America's national interest, then he and his administration should have done much more to mobilize public opinion.

We have heard it said here today that the American people didn't support this, the Congress didn't support it. Well, if the President thought it was in America's national interest, if it was just a vital issue that he was going to put American credit at stake then he had the obligation to bring this to the American people.

Last week during the State of the Union address, he spent three times as much time talking about $40 dinners with lobbyists than he did about a $40 billion loan guarantee with Mexico. He was more than an hour into his speech before he even mentioned the loan guarantee arrangement with Mexico. So how important was it for him if he gave it such a low priority in his State of the Union speech?

And as far as his activities on the Hill, we saw what the President can do when he wants something through. We saw what he did during the crime bill the way he lobbied Congress. We saw what he did during his budget proposal the way he lobbied Congress. And the fact that there was none of that going on, there was no effort to mobilize public opinion, there was no Oval Office address by the President. And then for him to suddenly turn around and say how essential it was in the first instance for Congress to act and then to say he could act on his own all along sends the type of mixed signal which I think has personified the foreign policy of this administration.

Quite frankly, I think it goes beyond—I think the lack of leadership that was shown here, the indecisiveness that was shown here is going to have a deleterious effect on all of our foreign policy, and I wonder what type of signal it sends to other foreign leaders around the country when they see the President say something is in the vital national interests, Congress has to act, he never speaks on it, and then he acts himself and doesn't even get any resolution

from Congress? I think it is a terrible, terrible failure and lack of leadership on the part of the administration. I say that as one who was inclined to support the President if he had done the right thing.

Chairman GILMAN. Thank you, Mr. King. Mr. Ackerman.

Mr. ACKERMAN. Thank you very much, Mr. Chairman. I hadn't intended to make an opening statement, but I would just like to comment on a couple of statements that were made much earlier in the opening statements and just say that I am shocked, shocked that some of our members would be appalled, appalled.

You know, this is a very complicated and intricate proposal that we are dealing with, much as the Contract With America. And the fact of the matter is, the Contract With America was signed about some 5 months ago—am I interrupting some kind of ceremony? The Contract With America was signed some 5 months ago, and yet we were here yesterday amending it and trying to improve it and make it better. This proposal on Mexico hasn't been with us quite so long and the change in the direction that the administration has taken on this yesterday certainly did not allow for as much fleshing out of the finite details as a 5-month proposal might have. So I think we have to exhibit a little bit of understanding when those kinds of things do happen.

And the fact that the Secretaries have indicated that they will be here within the next few days, I think is a sign of much good faith. They have not declined to be here. The criticism that I have heard, although I too am very disappointed that they are not here personally, although there are able Representatives who will hopefully explain to us as much this morning.——

Mr. ROTH. Will the gentleman yield?

Mr. ACKERMAN. In a moment, I will.

Nonetheless, the criticism that we have heard this morning about the Congress not being involved, we as Representatives of the American people from some of my colleagues on our International Relations Committee is somewhat puzzling to me, because as I recall, and maybe my recollection is faulty, but this committee did not even schedule discussions or debate or testimony on this issue at any time since this issue first surfaced, until the day before yesterday.

Now, how can we sit here in all good faith and be critical that we have not been able to participate in this discussion when this committee, until just momentarily ago, if I can be grammatically incorrect, scheduled for the first time ever an invitation to have people talk to us about this issue? It is a puzzlement.

Chairman GILMAN. Would you yield?

Mr. ACKERMAN. I would be delighted, Mr. Chairman.

Chairman GILMAN. This committee has been very cognizant of the sensitive negotiations between some of the leaders in the Congress and the administration, and we did not want to interfere with those sensitive negotiations. But once having seen a decision, I think now it is appropriate for the administration to come forward and discuss the implications of that decision.

I will be pleased to yield——

Mr. ACKERMAN. I have the time, Mr. Chairman.

Mr. ROTH. Will the gentleman yield?

Mr. ACKERMAN. I agree with the chairman and his decision 100 percent, and I think that the chairman's actions and decisions on this were very responsible and appropriate as the discussions and negotiations and dialogue were going on.

Mr. ROTH. Would the gentleman yield?

Mr. ACKERMAN. I will in a moment.

I do wish that the chairman, that it would have been possible for the chairman to make that assertion during the comments that Mr. Burton made when he was making the charges and allegations of not being able to participate in this process. Certainly, those remarks were appropriate at that time so that Mr. Burton would have understood and might have found some of his comments unnecessary that his participation was precluded because of those actions appropriately taken as just described by the chairman.

Mr. ROTH. Will the gentleman yield?

Mr. ACKERMAN. I would be delighted to yield.

Mr. ROTH. You asked us the question whether your recollection was faulty, and I just want to answer your question, yes, your recollection is faulty. You see, on November 8, the American people overwhelmingly backed the Contract With America, but 81 percent of the American people are opposed to the bailout. So I would tell the gentleman, my friend from New York, Mr. Ackerman, when in doubt, just follow the American people. Thank you.

Mr. ACKERMAN. Well, I try to do that. I tried to do that, but I think that the gentleman's interpretation of what I said perhaps is faulty.

Chairman GILMAN. The gentleman's time has expired.

Please let me caution—let me have the time a moment, Mr. Ackerman. Please let me appeal to our colleagues. We have four expert witnesses before us. We have now spent 40 minutes on opening statements. Their time is running; our time is running. I would urge my colleagues to please be brief. We don't want to cutoff anyone, but we are here to hear—have the benefit of their expert opinion.

I will be pleased to allow the gentleman to continue.

Mr. ACKERMAN. Thank you very much, Mr. Chairman.

The point that I made, and I thought that I made that point clearly, was that the Contract With America, which was signed before the election, did not have its details worked out, and I believe that was signed some time in August or September. You may correct me if, you know; I wasn't there at the signing. It wasn't something that I—my constituents wanted to participate in. But nonetheless, it seems to me that that was at least 4 or 5 months ago.

Chairman GILMAN. The gentleman's time has expired.

Mr. ACKERMAN. That was when—the point that I was trying for make.

Chairman GILMAN. Mr. Sanford.

Mr. SANFORD. Mr. Chairman, unfortunately, due to a previous commitment I am going to have to leave in a few minutes and for my opening statement I wanted to ask the witnesses a question, if I might.

Chairman GILMAN. Without objection.

Mr. SANFORD. My question is quite simple. One of the arguments you have heard for the bailout program is that if we don't do some-

thing in Mexico, it will spread throughout Latin America, and yet my understanding is that, for instance, Argentina has had a very disciplined, if you will, approach to monetary policy.

I would appreciate it if somebody would contrast for me in simple form, for instance, the difference between how Argentina has gone about monetary and fiscal policy versus Mexico's.

Mr. BERGSTEN. Argentina has——

Chairman GILMAN. Mr. Bergsten.

Mr. BERGSTEN. Argentina has a fundamentally different monetary strategy. They employ what is called a currency board, which means that every peso—the local currency—is backed by a dollar. That is like a gold standard of old. It simply means a country cannot expand credit beyond your international reserves.

The paradox of that, though, is that if capital inflow increases and reserves go up, the money supply also can rise very sharply, so it is not necessarily a good thing.

The point here is that the Mexican situation was and is unique in economic terms, but that markets do not necessarily follow such rational analyses. We have already seen that the Mexican crisis did lead to spillover effects, not only in Argentina, Brazil, and other countries in Latin America, but in countries throughout the world. Indeed, our own dollar was declining significantly in recent market sessions because of the effect on the peso. That is a partial answer to the question raised earlier of whether it is appropriate to use the Exchange Stabilization Fund to defend the peso.

I used to run the Exchange Stabilization Fund when I ran the international part of our Treasury Department in the late 1970's. The answer is unambiguously yes. We provided huge loans from the Exchange Stabilization Fund to rescue the pound sterling in the 1960's and 1970's when the pound sterling was cited by every governor of the Federal Reserve System and by every Secretary of Treasury as, "the first line of defense for the dollar." Nobody complained about that. It was perfectly appropriate. I don't suggest that the current situation is quite the same in degree, but the same relationship holds in principle.

Peso weakness was causing dollar weakness; it is therefore perfectly appropriate to use the Exchange Stabilization Fund, in part because the Mexican problem was spreading out to world financial markets and threatening a systemic crisis.

Chairman GILMAN. I thank the gentleman.

Mr. FAUX. Could I make a comment on that, Mr. Chairman?

Chairman GILMAN. Mr. Sanford, I think we have to move on. We gave extraordinary opportunity for you.

Mr. Engel, again, please, I appeal to my colleagues. We are now 45 minutes into openings. We are losing the benefit of our expert witnesses. Mr. Engel.

Mr. ENGEL. Thank you, Mr. Chairman. I will be brief.

I don't know how the loan guarantees have come to Congress, how I ultimately would have voted, frankly. I have very mixed feelings about it. But frankly, with all of the political harping and carping I have heard this morning, it is probably no wonder that the President decided to sidestep Congress and do what he felt he had to do. I was very happy to see the declaration of support here and see people from both parties; former Presidents, Secretaries of

State, Treasury and Commerce. It seems to me it is unfortunate that sometimes people who are not in Congress seem to rise above politics and can get their act together on an issue, and some of us in Congress are always political and we are letting the politics of the moment obscure or cloud the issue itself.

I would hope that we could look at this issue from a point of view of what is best for the United States, and not what is best to score political points against the administration. The President, when he doesn't act is accused of being indecisive. Now that he acts and is decisive, he has been accused of sidestepping the Congress. So, quite frankly, it is a matter of damned if you do and damned if you don't.

I want to associate my feelings with the remarks of Mr. Hamilton. I think it was well-known that the President had been negotiating with Congress for a long, long time and people, leaders of both parties were saying that the chances of getting these loan guarantees passed were becoming more and more remote by the moment. Maybe the reason it was more and more remote was because of some of the political rhetoric I have heard this morning.

Thank you, Mr. Chairman.

Chairman GILMAN. I thank the gentleman for his remarks. The last opening statement, Mr. Rohrabacher.

Mr. ROHRABACHER. I understand how my colleagues on the other side of the aisle feel compelled to defend this democratic administration, its misdeeds and its dodges which we are experiencing today. But I do find it a bit disconcerting to see my colleagues blaming us and trying to transfer the blame to us for what I consider the most outrageous insult to the American people and to the democratic process that I have seen in years.

A President of the United States saying, I can't negotiate this with Congress, so I am just going to find a way to do what I want to do without having Congress' approval. This is an absolute insult to this institution, to each and every one of us, and it is an insult to the American people. They are just going to be left out of the equation. We have to be concerned about the American people before we are concerned about the fat cat supporters of the President of the United States who invested in Mexico and now wants to have his cook—their cookies pulled out of the fire.

The bottom line is this situation was created—and I agree with my colleagues—by a lack of leadership by the President in the first place. Now we are in a crisis, and now I hear my colleagues trying to blame us, this institution? This is an outrage. It is probably criminal as well as immoral, putting our money up when we have acted responsibly, putting the money up that is supposed to protect the American dollar to protect the peso when they have acted irresponsibly is certainly a betrayal of our own people. And in the end, what we have done today—what this administration is doing is selling the insurance policy on our car and for our family's car in order to provide an insurance policy for our neighbor who can't get insurance because he doesn't have a good driving record. And that is going to be OK unless we have an accident. If a crisis comes up, we have given away the money that is supposed to be there to protect our own people's interest.

And this is outrageous. He has done this without coming to Congress. He comes to Congress and then he can't get the approval; he goes someplace else. This is an absolute outrage, and I might say that it is probably illegal as well.

I am looking forward to your comments, especially the one that just made the comment about what we did to the sterling and I hope that we find out whether that was effective or not in actually helping the sterling.

Mr. ACKERMAN. Will the gentleman yield?

Chairman GILMAN. I thank the gentleman for his opening statement. We will now proceed with the witnesses.

Mr. ROHRABACHER. I have no more time.

Mr. ACKERMAN. Your light is still green.

Mr. ROHRABACHER. I promised the chairman that I would give back the time.

Mr. ACKERMAN. Thank you.

Chairman GILMAN. Mr. Sweeney is a policy analyst with the Heritage Foundation and is the author of a recent analysis of the Mexican financial crisis. We welcome you, Mr. Sweeney.

We thank our witnesses for being patient through the opening statements, and we look forward to the testimony of our witnesses.

Mr. Sweeney, you may want to give a short statement or put the full statement in the record, whichever you prefer, or present your full statement before the committee. Mr. Sweeney.

STATEMENT OF MR. JOHN P. SWEENEY, POLITICAL ANALYST, THE HERITAGE FOUNDATION

Mr. SWEENEY. Mr. Chairman, members of the committee, thank you for this invitation to be here this morning.

Yesterday, I was joined on Wall Street, and on Mexico City I am sure that some people raised their champagne glasses toasting this brand-new bailout of the Mexican economy. Washington has once again bailed out Mexico, and it is going to cost U.S. taxpayers dearly. President Clinton invoked his executive authority yesterday to announce a unilateral resolution of the new Mexican debt crisis.

The President abandoned his ill-advised efforts to win congressional approval of $40 billion in Federal loan guarantees to bailout Mexico when it became clear that Congress would reject his Mexican Stabilization Act. This new plan, like the original one, is an improvised hodgepodge that will not solve the structural causes of the Mexican crisis. This new bailout plan is bad policy and it is bad politics.

The original bailout plan was a bad idea. This new plan is much worse. President Clinton has dropped any pretense of not dunning U.S. taxpayers for the cost of postponing a solvency crisis in Mexico for a few years more. Like the first plan, the numbers in this new bailout scheme are changing daily. Indeed, when we received at the Heritage Foundation yesterday the White House press release, you will note that the numbers pertaining to the IMF contribution were pencilled in to the press release. They were still figuring out at that time how much it was going to cost.

Like the first plan, the numbers in this new bailout scheme are changing daily. Yesterday, President Clinton's Plan B for Mexico was said to be worth $47.5 billion. This in this morning's papers;

we see that the bailout has risen to nearly $53 billion, discriminated as follows: $20 billion in commitments, not guarantees, commitments, from the U.S. Treasury's Exchange Stabilization Fund, which are to be used for short-term swaps, mid-term swaps, and guarantees of long-term Mexican bonds. In addition, $17.8 billion in direct IMF loans, $150 billion in direct loans from the Bank of International Settlements, $2 billion in short-term swaps from Canada and several Latin American countries, plus $3 billion in new loans from U.S. commercial banks.

It is worth noting some of the more outrageous elements of this new bailout plan. First, U.S. law authorizes President Clinton to tap the ESF for up to $36 billion if he wishes to expand the bailout even more. Second, the IMF's contribution is six times greater than Mexico was entitled to under IMF rules. IMF Director Michel Camdessus has said already that he will ask member governments and central banks, including the United States, of course, to contribute additional funds. Third, the $10 billion line of credit from the BIS is the largest loan ever made by that agency to a developing nation.

The Exchange Stabilization Fund was created in 1934. As Mr. Bergsten said here earlier, it has been used internationally before. Now, the ESF is going to be used to stabilize the Mexican peso and the foreign government and the money is going to come directly out of the pockets of U.S. taxpayers, confirming that President Clinton was misleading the American people and Congress when he pledged that the American people would not be paying for the bailout of Mexico.

However, the $20 billion in the ESF are only part of the bill American taxpayers may be financing out of their pockets. U.S. taxpayers are also going to underwrite part of the IMF loan and it is not clear yet what the governments of the other countries participating through the BIS will demand from the United States as a quid pro quo. U.S. taxpayers could easily wind up shelling out more than $40 billion, particularly if the $53 billion pledged by President Clinton are not enough to solve this Mexican crisis.

Will this massive bailout of Mexico end the crisis and restore investor confidence? The answer, in my opinion, is no. The U.S. bailout will buy more time for Mexico to reschedule its foreign debts yet again, and to borrow still more money, constantly expanding its bloated foreign debt to repay older debts as they come due. However, the bailout will not correct the underlying structural causes of the Mexican crisis.

The financial reasons for the peso's collapse have been described at length by Mr. Greenspan in testimony last week before the Senate Committee on Foreign Relations. However, the political causes of the peso's collapse have not been mentioned in depth here in Washington.

The political explanation of why the Mexican Government refused to tighten its monetary policy last year and why it drew down the Banco de Mexico's international reserves from $25 billion at the end of 1993 to about $6 billion when the peso was devalued on December 20 is that the outgoing President wanted to boost Zedillo's chances of winning the Presidential elections. Thus, Mexico's Government spent the country's entire savings to keep the peso

grossly overvalued throughout the year, reduce inflation even more, and facilitate billions of dollars of U.S. consumer goods so that more Mexicans would vote for Zedillo on August 21. This is classic Latin American populism. It is also evidence that Mexico, despite its immense economic advances of the past 6 years, has not progressed as far as its many friends and supporters in the United States have been led to believe by the Mexicans and by two U.S. administrations. Contrary to what Mexican law stipulates, this crisis has shown that the Banco de Mexico is not an autonomous bank but an instrument of Mexican electoral politics.

Now, President Salinas and his advisors gambled that confidence in Mexico would improve after the elections. I believe that they were also confident that if their political gamble failed, the U.S. Government would step in and bailout Mexico, as it has done frequently since Mexico declared a debt moratorium in 1982. According to the IMF's own data, Mexico in the past 12 years has refinanced, rescheduled, or restructured its foreign debt at least six times, including the Baker plan and the Brady plan, which was supposed to have ended the Mexican debt crisis in 1990.

The U.S. Government has been directly involved in these reschedulings since the start of the debt crisis in 1982, and the IMF has also been an active player in this. Between 1982 and 1992, Mexico rescheduled debts totaling $142 billion, obviously rescheduling the same debt more than once, and in the process increased its total foreign debt from $75 billion at the end of 1981 to $101 billion by the end of 1988. Yet, here we are again 4 years later with a much larger Mexican debt crisis about to explode in our faces.

Since 1988, Mexico's total foreign debt—public and private, short-term and long-term—has increased to about $160 billion, of which at least $71.3 billion is due for payment this year according to financial analysts at First Chicago in New York. Assuming that First Chicago's estimate is accurate, then about 44.5 percent of Mexico's total foreign debt matures this year. Moreover, the foreign debt due this year is 60 percent greater than Mexico's total exports in 1993, while the total foreign debt today is equivalent to nearly 67 percent of Mexico's GNP since December's devaluation. Clearly, this is not a transitory shortage of liquidity. How many more Mexican bailouts must American taxpayers suffer at the hands of irresponsible administrations in Washington before America's leaders realize that the solution is not in Washington, but in Mexico City?

The Mexican crisis needs a stronger free market cure than Mexico's ruling political, corporate, and labor elites are willing to accept. The Heritage Foundation's recently published Index of Economic Freedom qualifies Mexico as one of the least free economies in the Western Hemisphere. Mexico has undergone a vast and highly positive transformation in the past decade. But Congress should also note that this crisis has already compelled President Zedillo to announce a number of important reforms, which the previous government of President Salinas had resisted.

For example, foreign investors will now be allowed to own 100 percent of any Mexican financial institution, and the privatization of state enterprises is being relaunched. On the political front, President Zedillo is pushing much needed political and electoral re-

forms that Salinas largely ignored. Nevertheless, Zedillo's plan relies too much on an IMF-style adjustment program—more devaluation, more wage restrictions, tax increases, among others—that will benefit Mexico exporters but will impoverish everybody else in Mexico. To a great extent, the Mexican experience since 1982 has been a model for managing the debt crises and balance of payments problems of developing countries everywhere. However, this new crisis has been a shock to everyone who thought Mexico was doing everything right.

Mr. Greenspan has acknowledged as much in congressional hearings last week when he made the following statement: ". . . once the Mexican situation is stabilized, it will be important for the authorities of leading governments to examine closely the lessons to be learned from this latest episode in international finance, and to determine how to deal with similar emerging financial problems that have implications for the health of our free market-based international financial system."

My translation of this statement, into everyday words every American can understand is this: Something is seriously wrong here. This crisis should not have happened and these continual bailouts are not solving the problem.

The Mexican Government is counting more on President Clinton's bailout than on fixing what is wrong with the Mexican economy. However, U.S. loan guarantees will not restore the Banco de Mexico's credibility, nor will a U.S. bailout of Mexico restore consumer confidence any time in the foreseeable future. Electorally motivated monetary policies is going to require years of hard work by the Mexicans.

In the 1982 debt crisis, the hardest hit investors were the international commercial banks who spent most of the 1980's restructuring their Latin American portfolios. This time around, the banks were largely out of harm's way. A new breed of investors has been burnt. These are the mutual funds and other institutional investors who amassed a savings of millions of small investors and then, presumably, invest these savings with the appropriate prudence and caution. Even if Mexico manages to squeak out of this new debt crisis, in the opinion of New York bankers I have spoken to in the last 2 weeks, this second generation of investors will not come rushing back into Mexico any time soon.

One of the Clinton administration's arguments in support of bailing out Mexico has been that without a bailout, the Mexican people will suffer a great hardship. Let me assure you that the Mexican people are already suffering and will continue to suffer for many years. Before December's devaluation, the average Mexican citizen's standard of living was between 30 and 40 percent lower than it was before the 1982 debt crisis. Before the Chiapas rebellion erupted on January 1, 1994, Mexico's Gross National Product was about $350 billion. The peso's devaluation measured in U.S. dollars literally evaporated more than 40 percent of Mexico's national wealth.

Today, Mexico's GNP is about $240 billion and it is heading south. The Mexican people are not going to recover from this economic blow for at least a decade. For the next several years, slower growth of the Mexican economy, higher inflation, higher interest

rates and higher unemployment will compel a significant increase in the number of Mexican illegal immigrants entering the United States.

Administration arguments that U.S. exports and jobs will be hurt if the United States does not bailout Mexico are also misleading. The damage has already been done. No one has yet provided accurate estimates of the losses U.S. exporters will suffer as a result of the peso's devaluation, but if one assumes that between $10 and $15 billion in annual U.S. exports may be lost or simply not realized due to expressed consumer demand in Mexico, some 200,000 to 300,000 U.S. jobs are going to suffer any way.

The new Mexican bailout scheme as described yesterday by the administration is an affront to the American people and to Congress. Reliable opinion surveys show that more than 70 percent of the American people oppose any bailout of Mexico. President Clinton abandoned his original proposal of $40 billion in loan guarantees because Congress wisely refused to be rushed into making reckless decisions without weighing the merits of the Clinton plan, the extent of the Mexican crisis, and whether or not the bailout would actually work. Now the President has invoked his executive authority to act unilaterally. According to news reports yesterday, Republican and Democratic leaders apparently have endorsed the President's new plan because it will not require a congressional vote and, therefore, will not require any congressional accountability to the American people.

I fervently hope that Congress will continue to oppose this outrageous direct transfer of wealth from the pockets of American taxpayers to the pockets of Mexico's elites, and to the pockets of a privileged group of financial intermediaries who want their bad investment decisions forgiven at taxpayer expense. The Mexican crisis will not go away with this bailout. Instead, Mexico will return to Washington years from now seeking another and a bigger bailout. Meanwhile, the negative effects of the peso's collapse will be felt acutely in Mexico for many years, and to a far lesser extent in the United States as well. President Clinton's Mexican bailout scheme would make the American people hostages of Mexico's corrupt electoral politics. Congress must not allow this to happen.

In closing, supporters of the Mexican bailout have warned that American leadership in the world is at stake and that not facilitating more foreign loans to Mexico will cause a worldwide financial collapse analogous to the Chernobyl meltdown in the former Soviet Union. I believe that any U.S. bailout of Mexico will send the rest of the world the wrong signal. Bailing out Mexico will tell governments in emerging markets everywhere that bad policies based on short-term political imperatives will be forgiven, and it will send private investors a message that bad investment decisions will be bailed out at U.S. taxpayer expense.

I also discount the alarmist assertions of those who believe that financial collapse will follow any denial of U.S. assistance to Mexico. Certainly, Mexico would announce a debt moratorium and probably impose exchange controls, but I believe the Mexico Government also would move quickly to apply the structural corrections that Mexico needs.

The truth is that no one knows for certain what would happen in the global economy if Mexico is denied any U.S. loan assistance and is compelled to seek a market solution to its new debt crisis. I believe there would be a sharp market correction, but nothing even close to the worldwide financial collapse claimed by the Clinton administration and Wall Street.

Finally, I believe that Congress should look into the role played by the U.S. Federal Reserve in this crisis. The Federal Reserve is supposed to be independent from the executive branch of government, and here we have a case where it is doing President Clinton's dirty work. The Mexican crisis has confirmed that the Banco de Mexico is a tool of Mexico's politicians. Can it be that the U.S. Federal Reserve has become a tool of White House politics and Wall Street as well? Thank you.

Chairman GILMAN. Thank you, Mr. Sweeney.

[The prepared statement of Mr. Sweeney appears in the appendix.]

Chairman GILMAN. Before proceeding with the rest of our panelists, if I could invite the panelists, if they would care to submit their statements in full to be made part of the record, and if they would summarize their testimony, I think we would be able to get on with the dialogue at an earlier time.

At this time, I welcome Dr. Fred Bergsten, who has been the Director of the Institute for International Economics since its creation in 1981, and had been Assistant Secretary of the Treasury for International Affairs during 1977 through 1981, Dr. Bergsten.

STATEMENT OF MR. C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BERGSTEN. Thank you, Mr. Chairman. Reverting to your earlier comment this morning, my colleagues and I at the Institute did burn some midnight oil to try to present a statement to you. We have it; we will submit it for the record, and I will summarize it.

I would particularly like to thank my colleague, Dr. William Cline, who is here with me and burned most of that midnight oil. He has, in fact, just completed a book called "International Debt Reexamined". This is a comprehensive analysis of the debt crisis of the 1980's and its lessons for the current crisis. We will be publishing that on February 9. I would commend it to you. We draw on that in-depth scholarship and research in our presentation today.

Chairman GILMAN. We will conduct——

Mr. BERGSTEN. I was going to tell you that we had presented the first comprehensive analysis of the new package within 24 hours. Then I heard a number of the considerations raised by your members this morning. I will not claim that we have a totally comprehensive analysis, but we have tried to address the main features of the problem, as follows.

Let me first say that I strongly support the current program, but I by no means support everything the administration has said or done. So let me make that distinction. I am certainly not acting as any surrogate for the absent Secretaries from the administration, but am giving you rather a sympathetic, but a completely independent view.

My bottom line is that this program that was announced by the President yesterday is a good program. It is necessary. It will work. It deserves the support of the Congress. Let me go through, at least briefly, my analysis of why that is true.

The first point, which I assume does not need to be proven, is that Mexican economic stability and prosperity is in the interest of the United States. If anybody wants to challenge that, I would be delighted to discuss it in depth. But the question is, what is the nature of the Mexican economic problem?

The first witness characterized it as resting on deep structural problems that could not be changed by the proposed package. I take a very different point of view on two fundamental counts.

First, I characterize the current problem as a classic liquidity problem, not one resting on deep structural, underlying difficulties. I am obviously not saying that Mexican economic policy is perfect; certainly no country, including our own, could claim that. But the current Mexican problem, I think, is a classic liquidity problem, by which I mean the following: they have short-term debt coming due in the next few months which exceeds their foreign exchange reserves. If there was no augmentation to their foreign exchange reserves, they would be forced either to default on that debt, declare their currency inconvertible, apply exchange controls or some mix thereof, all of which would make the conditions and effects on the U.S. economy, stated earlier, much worse. Such actions would make the effects on the Mexican economy much worse, too. For both reasons, I think this package is very much in our interests.

Why do I say it is a liquidity problem and not something related to much deeper structural problems in Mexico? Let me list a few of the achievements of Mexican economic policy in recent years.

Over the last decade, the Mexicans have applied the equivalent of five Gramm-Rudman corrections to their budget. As I speak to members of this body who sometimes righteously attack other country's economic policies, I would underline, Mexico has achieved the equivalent of five Gramm-Rudman improvements in its budget position over the last decade.

The Mexican operating budget moved from a deficit of 8 percent of their GDP 12 years ago to a recent surplus of 7 percent. That is a swing of 15 percent in their budget position, not a painless adjustment, as members of this body know. That is on the operating budget. If you include interest payments on debt, their aggregate fiscal position is roughly in balance, something I would not suggest justifies a characterization as "profligate fiscal policy" by any outside observers.

In addition, as indicated by the governor of the central bank's Op-Ed in the *Wall Street Journal* yesterday, Mexico's money supply increased by about 6 percent last year. This is about the same as ours, which is not bad and certainly not a profligate extension of monetary policy.

In my view, the Mexicans ran into one severe economic problem: They ran a huge trade and current account deficit because they let their exchange rate become overvalued. Again, I don't suggest there are no other difficulties in Mexico, but I suggest that this crisis was brought on mainly by a single problem, a problem that Italy brought on itself in 1992, the United Kingdom brought on itself in

1992, and the United States brought on itself in 1971 and 1973. Countries, even those we like to think of as the best managed, do from time to time make mistakes—they let their trade deficits get large and let their exchange rates become overvalued so that they require correction.

Ten years ago, the U.S. dollar, as many of you will recall, became enormously overvalued because of the shortcomings of Reaganomics. The dollar rose 80 percent from 1980 to 1985, created trade deficits in the United States of $160 billion, and converted us from the largest creditor country in the world to the largest debtor in 2 years, a dubious position that we continue to hold. Therefore, we should all be a little humble in levying conditions on other countries.

Now, having said that, there are a couple of very important points to point to. There will be substantial conditions on this package of loans to Mexico. They will be carried out through the International Monetary Fund, which is the right way to do it institutionally and politically. They will be tough conditions, like those the IMF has levied on country after country. Recall, indeed, that the main criticism of the IMF is that it is too tough, that it enforces austerity, and that it is driving countries into the wall, not that it is too soft.

This package, quite properly in my view, relies on the IMF to assure that Mexican economic policy will be effective and will use the financing in an appropriate way. But I am starting from a base that the underlying problem is not deep structural difficulties, but rather a significant policy mistake.

Let me make two other points on Mexico before I go on. The first witness suggested that Mexico has the least free economic policy in the hemisphere. I have no idea where he got that notion. We published an in-depth study last summer called "Western Hemisphere Economic Integration", an in-depth study of every country in the hemisphere that underlay our suggestions for what was done at the Miami Summit and regarding extension of NAFTA to the Western Hemisphere. We calculated what we called "readiness indicators" for every country in the hemisphere in terms of its ability to qualify for the NAFTA and to do a free trade agreement with the United States. That is, we ranked the countries on the openness and appropriateness of their economic policies, their macroeconomic policies, trade policies, investment policies, and the like.

We found Mexico near the top of the list. I would be happy to debate the former witness on the details of that, but I find it very hard to believe that some opposite conclusion came out of serious analysis about these countries' outcomes.

A final point on Mexico regards what I think in the first witness' statement was a flat contradiction. On the one hand, he argued at the end that the Mexicans are going to be bailed out and that this will send a terrible lesson to other countries around the world. On the other hand, throughout his statement he told us about the huge losses already incurred by the Mexican economy, including a 40 percent decline of the dollar value of their GNP.

His second point is correct. His first point is therefore incorrect. There is no bailout for the Mexicans. The Mexicans and the investors have already suffered huge losses. We could inflict more losses

on them and help drive them further into the ground by refusing this kind of credit, but it seems to me that would be insane from a U.S. standpoint as well as the standpoint of any empathy we might have for the Mexicans themselves.

What about the second major point in this debate, that this, again to quote the first witness, will cost the American taxpayers. I regard that as a totally fallacious, indeed irresponsible, statement. The Exchange Stabilization Fund does not spend the money of the American taxpayers. It is a classic revolving fund. So is the International Monetary Fund.

As I told you, I ran it for 4 years. What you do is activate swap agreements, enter the exchange markets with intervention and then reverse the transactions and recoup. There is no net cost to the American taxpayer, unless of course the Mexicans did default and the guarantees, to the extent there were guarantees involved, had to be called. On that, the defenses seem to me to be ironclad.

I am told that Ross Perot even testified yesterday that the collateralization of the Treasury credits via its first claim on Mexico oil revenues is "impregnable." If Ross Perot says it, it must be right.

It seems to me that there is no threat to the American taxpayer. Indeed, the United States will make money on the deal because of the very large fees involved.

The third and final point I want to make in my summary statement for this House International Relations Committee is that we are witnessing here a very serious blow to U.S. world leadership. The President did fail to lead effectively in educating the public, bringing the Congress along with him to do what I think was the better alternative, the legislative deal. I believe the congressional leadership failed, because, after all, they endorsed the deal with the President 3 weeks ago and then they failed to bring along the rank and file. I think the rank and file failed, because they read the polls that said 80 percent of the public was against the package and therefore followed willy-nilly, when any objective reading of the circumstances clearly called for doing something of this type. So I do think this was a rather bad show in terms of the U.S. world role.

Let me characterize it in the following way: If the United States could not come up with the proposed legislative package for its closest neighbor, which is its second largest trading partner, which is a NAFTA partner, in a deal structured to make money for the United States, what can the world count on the United States to do? And that, members of the committee, is a message that is not confined to Mexico City or even Buenos Aires; it is being heard loud and clear in Tokyo, London, Paris, Bonn, and every other major capital in the world. I hope the President's new package, which is inferior but still adequate and good, will turn the tide and recoup. But I think there has been a serious loss to U.S. foreign policy and world leadership that I hope will not be too debilitating.

Thank you very much.

Chairman GILMAN. I thank the gentleman for his testimony.

[The prepared statement of Mr. Bergsten appears in the appendix.]

Chairman GILMAN. We will proceed now with Dr. Baer. Dr. Baer is the Deputy Director of the Americas program, Director of the Mexico Project at the Center for Strategic and International Studies. We welcome Dr. Baer. You may proceed, either read your full testimony or summarize it and put the full testimony in the record. Dr. Baer.

STATEMENT OF DR. M. DELAL BAER, SENIOR FELLOW AND DIRECTOR, MEXICO PROJECT, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

Ms. BAER. Mr. Chairman, thank you very much for the invitation, Mr. Hamilton, members of the committee. I, too, will submit my statement for the record and summarize extemporaneously, hopefully as elegantly as Fred Bergsten did, what I spent last night burning the midnight oil writing.

I think I was invited to testify before the committee today as a political scientist and a specialist on Mexican affairs to try to give you a window into what is going on on the other side, to try to flesh out a little bit that precarious statement that moved the President to an extreme sense of urgency. I think I am here to provide you with a sense of what it is you might have to say to your constituents who legitimately ask, why are we engaged in this endeavor if we don't act and then later have to face a national security crisis on our southern frontier. I happen to be someone who believes that the risk of that is far too great for us to play with.

But before I go to the heart of my argument, I would like to make just a very few comments on the issue of conditionality and U.S. foreign policy, because I think that in the aftermath of the Mexican loan guarantee crisis, there is a good opportunity to reflect on the merits of cross-issue linkage, and conditionality is a tool of foreign economic and diplomatic policy, particularly as it plays out in congressional deliberations.

To me, common sense would suggest that it is impossible to achieve all of our foreign policy objectives at the same time, or in one piece of legislation. I think this is particularly true of the complex U.S.-Mexico bilateral agenda, an agenda that includes an enormous laundry list of daily obligations and problems that are long-term in nature.

I guess my question to you is how can we do justice to thorny issues like immigration, prisoner exchange, agricultural imports, Mexican relations with Cuba, poverty in Mexico, the trade union movement in Mexico, et cetera, et cetera, et cetera, by tacking them on to a financial crisis in the heat of the moment?

I think the concerns that have been expressed by various members of the committee are, indeed, truly legitimate, and I share many of your concerns. I guess I would only suggest it seems to me we may be able to address some of them more effectively and we may be able to accomplish your objectives more effectively if they are treated in and of themselves.

I don't think that this is a trivial procedural issue, and my fear is that when we try to link every issue, we end up solving none, and we all walk away from the table without anything. And in the case of Mexico, conditionality on this last go-round, in this last congressional process, threatened to cripple our ability as a Nation to

conduct a credible foreign policy. As Fred Bergsten mentioned, other nations were watching the fiasco and were wondering if the United States cannot act when a crisis threatens Mexico on its southern border, when will it act? This free-for-all discussion over Mexico has set precedents that I feel will weaken the institution of the Presidency and tie the hands of future Presidents, both Republican and Democrat.

Now, I would like to turn for just a minute to addressing some of the domestic political issues in Mexico that are raised by this financial crisis.

Let me just recall for everyone here that Mexico is a country that is now recovering from two deeply disturbing political assassinations that occurred last year—an active guerrilla movement in the southern state of Chiapas and a very heated Presidential election in 1994—that I believe resulted in probably the cleanest election results that I have ever seen as an observer of Mexican elections, and I have been observing Mexican elections regularly since 1982 and organized a delegation of 16 well-known academic observers of Mexico to observe these elections.

Our conclusions about those elections was that while there remain issues that need to be resolved in Mexican electoral law, I think we all looked very hard, I went into the backwoods looking for fraud and very few of us were able to find the egregious fraud that we have seen in previous years. So I think that we are talking about a country that is an emergent democracy with all of the vulnerabilities that that entails, just as emerging financial markets entail.

I don't think the United States can afford to take the stability of Mexico for granted, especially in an age when Zhirinovsky-style demagogues and hypernationalist populists are populating the post-cold war landscape. This is something that I think we need to take very seriously. Mexico's financial crisis could easily have turned into a national security crisis were it to linger for too long, and I think it is something that we need to think about very, very seriously.

I would take issue with the comments that were made earlier by Representative Brown, who is not with us at the moment, characterizing Mexico as a one-party dictatorship. Mexico is, of course, a country that has the longest single party dominant system in the world, and that is something that is certainly of enormous concern. But I would have to insist that Mexico is in the midst of a delicate transition to complete, full democracy as we would recognize it, and that transition is a delicate one and a fragile one and one that can be directly impacted by how this financial crisis is managed.

I would just point out a very few—I don't want to get into a long discussion of this—improvements in the Mexican electoral arena. They now have independent electoral authorities, institutionally constituted and with independent citizen criteria. The United Nations, as well as many academics and other nongovernmental organizations, did send observers to the 1994 elections and many of the most credible of those institutions did seem to believe that this constituted an enormous improvement in the Mexican political scene. There are now opposition governors ruling in Mexico, which sug-

gest to me that we are clearly moving to a more open—the trend is clearly toward a more open political environment in Mexico.

How does the financial crisis play into this situation?

Well, President Zedillo clearly no longer commands political discipline and the PRI is increasingly independent. It is a very interesting development and relatively recent. If efforts to stabilize the Mexican economy waiver, President Zedillo could be challenged by a hard-line wing of his very own party and opposition forces that are unfriendly to economic reform, wary of the United States, and resistant to continued political opening. What I am saying here is that populists, nationalists, and authoritarians tend to flourish in an environment of economic crisis.

So President Zedillo right now faces a paradox. Mexicans and Americans have long complained very loudly of insufficient democratization in Mexico. But we are now seeing more democracy in Mexico and a very feisty Congress, for example, that was very concerned about the conditionality that was attached to the bailout package and that was likely to take a strong oversight role. I have been watching Mexican politics for many years. I have never seen them act quite so independently in exercising its oversight capabilities. At the same time, Americans don't seem to understand why President Zedillo can't seem to snap his fingers and deliver currency that is privatized for Mexico tomorrow and do everything that we would like to see him do. It is a bit of a paradox. Zedillo, I think we need to characterize him as a struggling Democrat with a small "d." He needs a little patience, understanding, and some very rapid economic action.

Let me make a very few comments on our bilateral relations with Mexico, because many observers of Mexico right now are very worried that the loan guarantee debacle and the debate has done a lot of damage to the bilateral harmony and that it will take some time to mend. For a while, as I was watching the crisis unfold, it almost seemed as if the United States would stabilize Mexico financially and destabilize Mexico politically. I kept looking for the story on the front pages of the newspapers and never saw it, and it was clear that we were unaware of just how precarious that political situation was in Mexico.

The government of Ernesto Zedillo was in an impossible position. Every step that he would take to try to accommodate the concerns of Congress brought him one step closer to the political abyss at home. Trying to accommodate congressional conditions in the United States turned up the nationalist heat in Mexico.

I wish I had some of the newspaper front pages to show you the enormous columns in front page headlines that were spewing out a lot of hypernationalistic rhetoric on this issue. Americans seem to be oblivious to the fact that we were asking a fragile government virtually to commit political suicide.

I have to point out, though, that the United States and Mexico have made an enormous effort over the past 12 years to overcome our history of mistrust and wariness and we have begun to edge toward real trust in the bilateral relationship and that process culminated in NAFTA. And that approachment, that historic approachment served as a model for every country in the Western Hemisphere and Latin America. Argentina and Brazil decided that

perhaps they could move closer to the United States if the Mexicans did.

Why should we care about this? Put simply, the United States needs to handle our bilateral relations carefully, not because we are such nice guys. Obviously, we have our own interests at stake here. But our interests are served by having a good, working, practical relationship to address our problems with Mexico. We have a day-to-day relationship on that border that needs their cooperation. We cannot solve these problems alone. So it is very important to us to try to preserve the kind of relationship that will permit us to move forward on all of the concerns that we share in the bilateral agenda. I can't stress how important that is.

I am going to just make one final comment about Mexico's market economic revolution, not very long, because I can't begin, I think, to compare to the knowledge, the depths of knowledge of a fine economist like Fred Bergsten.

Mexico's financial crisis is obviously giving new life to those who never believed in Mexico's market reforms to begin with. A critique is needed. We need to try to understand why this crisis fell so far and so fast. But we need to be very careful not to stimulate those who would like to throw the baby out with the bath water. And I have to suggest that Jack Sweeney, for example, his demands that could potentially strengthen the hands of those in Mexico that you least agree with, and I am very worried about that.

Let's remember, Mexico was the birthplace of the very first social revolution of the 20th century, predated the Soviet revolution, the revolution of 1910. And Mexico has always been a trend leader, first in social revolution and then in the post-cold war economic market revolution. Now, many of us in the United States, myself included, believe that Mexico's market reform has not gone far enough. I also would like to chime in and share the views of those who believe it must go further. But let's remember that there are many in Mexico, apparatchiks, what have you, dinosaurs, as they are called colloquially in Mexico, who also believe that the market reform revolution has gone much too far and they would like to stop it.

And we need to have at least a little sensitivity to the fact that there are—it is difficult for Mexico to privatize PEMEX as it is for the United States to privatize social security, as much as I would like to be able to manage my own savings and my own retirement funds. So we need to realize that we will accomplish our objectives in supporting further market revolution in Mexico with a light touch than with a heavy touch.

Finally, rapid economic stabilization is obviously key to social stability in Mexico. For the first time Mexico is confronting the prospect of increased social instability. Although, I would point out that the media spin of the Chiapas guerrillas is far greater than their military reach, they are masters of the spin. They don't appear to have a capability in other parts of the country at this stage of the game. Still, I have traveled all over Mexico and I know that there are pockets of misery throughout that country that are fertile to terrain for political anger. And I think that returning Mexico to economic stability and returning hope to Mexicans is probably the

best thing we can do to try and guarantee economic and social stability in Mexico in the years to come.

Thank you very much.

[The prepared statement of Ms. Baer appears in the appendix.]

Mr. BEREUTER [presiding]. Dr. Baer, thank you very much, especially from the political perspective. We appreciate your testimony.

Dr. Faux, you may proceed as you wish.

STATEMENT OF MR. JEFF FAUX, PRESIDENT, ECONOMIC POLICY INSTITUTE

Mr. FAUX. Thank you, Mr. Chairman. Unlike my colleagues, I spent what little midnight oil I had last night burning it for other reasons, so I don't have a written statement this morning. I was just asked to come over yesterday afternoon. But I will be happy to submit one later, if you would like.

I think what we have here, Mr. Chairman and members of the committee, is a crisis of U.S. policy as well as the crisis we have been talking about in Mexico. And I would like to put that in a little perspective.

One can argue that we have no choice but to go through some sort of bailout of the Mexican financial system at the moment. And yet it seems to me we are in a situation where at each stage of the game in our recent relationship with Mexico, we are told we have no choice. We must do something unintelligent and distasteful because 2 years ago or a year ago we did something unintelligent and distasteful. At each stage of the game we focus on what is in front of us now, how to solve the crisis. I suggest that we are going from crisis to crisis, and there are a number of unexamined assumptions that our policy is based on that are leading us into more and more risky terrain.

Whatever you think about the bailout, it is quite clear to me that we are signaling the world, the financial world, that the United States will be responsible for putting a safety net underneath the Mexican financial markets. You may think that is a good idea, you may think that is not a good idea, but we haven't debated that in this country. Some of us raised that question during the NAFTA debate but it was generally ignored. Essentially, we are taking responsibility for a situation where we have no authority. The writ of the SEC stops at the border. The Federal Reserve Board is not responsible, and has no authority for regulating the monetary supply of Mexico. And yet we are now taking responsibility for undergirding that system.

I believe it is an unstable situation. I think that we know enough about the Mexican economy and the political system to know that the financial markets are rife with conflict of interest. There is a very, very fuzzy line—or no line in many cases—between the government and private people in the stock market. This bailout will perpetuate that system. There is nothing in the proposal that will change the fundamental problem that we have, on the contrary, it will encourage continued speculation, and not do anything about the basic problem confronting Mexico, which is its debt. As a matter of fact, the bailout it adds $50 or $60 billion more to the debt that Mexicans have to pay off at rather high interest rates. I think this sets us up for another crisis.

The loan package, which is apparently is going to go through I think reveals that much of the promises of NAFTA were false. The vast consumer market that we were told would create jobs and prosperity in the United States now is on hold. For how long? No one knows. Five years, 10 years, 15 years? The promises are beginning to unravel.

Many people observed during the NAFTA debate that the trade surplus with Mexico, upon which supporters based the forecasts of new job creations, was not so much a reflection of market liberalization in that country, but a reflection of the high overvalued peso. That observation has turned out to be quite true. As a result of this, bailout or no bailout, I would have to say real wages in Mexico will go down even further. The Mexican people will be subjected to more austerity, and the effect on the United States will be to drag wages down in those industries where U.S. workers compete with Mexican workers. There is nothing here, nothing in this package to deal with that.

People who were telling us that we would have large and expanding surpluses after NAFTA was enacted are now telling us the surplus will change to a deficit in 1995. And suddenly, we are given to believe that jobs don't count any more. Now it said that NAFTA was not about jobs. But that is not what was said when NAFTA was being promoted.

We are told that the bailout is riskless. It may prove to be riskless. No one knows the future. But if it is so obvious to people in Washington that this deal carries no risk, why is not the private sector out there making these loans? If this is simply a cash crisis, if this is simply something of a little cash squeeze that we just have to get through, why does the U.S. taxpayer need to be involved? People go to private banks to get short-term loans to deal with their cash crisis. It seems to me the markets are making another judgment, and I think we have to look at that very carefully.

The policy basis for a lot of these decisions over the last few years has been based on unexamined conjecture and lots of wishful thinking. People who are telling us that they could not have forecast the market reaction to the Mexican devaluation are telling us confidently that they can forecast what would happen if we didn't have this bailout. We have a sort of domino theory again. That is, if Mexico goes, so goes Brazil, so goes Argentina, so goes Czechoslovakia. We have been down that road before.

It seems to me we have to ask some simple questions. Why would someone who has a good business deal in investing in real plant and equipment in Argentina not invest now because the Mexican Government mishandled its economy? I think we are in danger of confusing what goes on in financial markets, volatile financial markets subject to short-term movements of capital around the world, with the real economies that produce goods and services. I would suggest that the fact that the stock market in Argentina or Brazil dropped 8 percent in the last couple of days is an insufficient reason for us to be taking this kind of a step.

We will not make friends in Mexico with this. The Mexican people after 10 years of austerity are now facing a long recession and probably, as was pointed out here by Fred Bergsten, even more austerity forced by the IMF. So that this wonderful market for

which we dedicated our agreement to NAFTA has disappeared for a while, maybe for a long, long time.

I think it is time to rethink our basic economic policy here. It is not a question of being for or against free trade; it is not a question of being for or against Mexico. But we have attempted to move along a path reflecting the idea that the United States will not prosper unless it increases trade rapidly with emerging markets around the world. This has been the cornerstone of economic policy for at least the last two Presidents. This has reinforced the infatuation with investing in the Third World, and we are now here talking about one of the results of that notion.

You have to ask yourself, why did Mexico draw down its reserves? And here I have to agree with my colleague from the Heritage Foundation, I never thought I would hear myself say this, that this was essentially a political motivation. Throughout the NAFTA debate, it was obvious that the peso was overvalued; it was kept overvalued in order to have a favorable effect on the election. It continued to be overvalued after the election. Sooner or later it was bound to come down. Many people predicted this a year ago, even 18 months ago. And so it has happened and it will happen again because the basic, the basic structural problems have not been solved.

The peso crisis gives us a glimpse of where we are heading. We now have to prop up foreign economies in order for their people to be able to have enough money to buy our goods because we have decided that is the only way we are going to sell the goods that we produce. At the same time we are forcing austerity on the United States, cutting back programs here. It seems glib to ask, well, if we are bailing out Mexico, if we are guaranteeing loans to Mexico, why not bailout Philadelphia? Yet the question has not been answered. I think we have some contradictory economic theories at work here, and all of this needs fundamental examination. We are not going to stop this deal. But I think we are going to have to think about where we are going.

I, quite frankly, could imagine us having a sensible arrangement to bailout Mexico. I think we have some responsibility for our neighbor. But I think we have to broaden that discussion to include things like labor rights and standards to assure that the kind of market we are setting up in North America is one that will provide prosperity for workers on both sides of the border.

Right now we are facing more real wage decline in Mexico, partly from this crisis, partly from a government policy that deliberately keeps wages below inflation. This will have an adverse effect on living standards here. We are told that we have to do this in order to save jobs in the United States by the Chairman of the Federal Reserve Board. And yet this morning everyone expects that the Fed, if they haven't done it already, will raise interest rates because it thinks that there are too many jobs being created in the United States. I think we have got to get some of these policies straight.

The *Los Angeles Times* tells us that 81 percent of the American people think this is a bad idea. *La Reforma,* a newspaper in Mexico City, as it was reported in the *Wall Street Journal* yesterday, tells us that 74 percent of the people in Mexico City think this is a bad

idea. Of course, the reaction here is that the people don't know what they are talking about. I would submit that over the last 10 years, the people who have been running economic policy in this town haven't done such a great job either.

Thank you.

[The biography of Mr. Faux appears in the appendix.]

Chairman GILMAN [presiding]. I thank our panelists for their expert opinion. Please forgive our members who have been going in and out of a meeting that we have here in the anteroom. We had some distinguished visitors and they will be rejoining us.

Mr. Bergsten, you emphatically note that Mexico does not have a structural trade problem, but doesn't it—in fact? Mexico's worth as a valuable NAFTA partner, having been a purchaser of many goods, including consumer goods, indicate that it may have an emerging long-term structural problem up the road?

Mr. BERGSTEN. I don't think there is a long-term structural problem, Mr. Chairman. But let me explain that. Any country with a relatively low per capita income like Mexico that is properly characterized as a developing country quite naturally runs a trade and current account deficit. Any country at an early stage of development is by definition investing a lot, probably more than it saves at home; it therefore does import capital and that means it runs a trade and current account deficit. That is nothing unusual. All the Asian tigers have done that. Korea has done it. Indonesia has done it. All of the development success stories in the modern world have done it. When the United States was a developing country in the late 19th century, it did it with a vengeance. So the fact that Mexico ran such deficits is nothing unusual.

The question is, how much of a deficit? Mexico let that external deficit rise to an excessive share of its economy, about 8 percent of the GDP of late. That, by our calculation, was about twice the amount that was sustainable.

Further, the Mexicans were misled by the big inflow of foreign capital. It is often forgotten that as recently as a year ago, February of 1994, the Mexicans were getting so much foreign investment that they were trying to fend off the adverse effects of getting too much money. It turned on them quickly, obviously, and they were shortsighted not to recognize that could happen.

But I think we should expect and support a Mexico that could, as a steady-state proposition, run a deficit in its trade and current account of something like 3 to 4 percent of its GDP. That would be financeable by an inflow of stable money: direct investment and long-term capital, not the hot money that provided this extra financing over the last year and then ran back out. Such a long-term, modest deficit in turn is the flip side of our running a trade surplus with them, which is, as Mr. Faux said, a net job creator here.

Chairman GILMAN. Would any of the other panelists care to comment on that question?

If not, why did you think the President spent such a lengthy period of time, several weeks, in developing a loan guarantee proposal for Mexico if he felt he essentially could accomplish the same objectives by using the existing authority and doing it quickly without the prolonged delay?

Mr. BERGSTEN. I think there were two reasons, Mr. Chairman.

Chairman GILMAN. I address that to the entire panel.

Mr. BERGSTEN. These are purely my own personal reasons, but I think there were two good reasons. First, I believe the legislative package would have been superior to the package that has now been announced unilaterally. It would have shown across the board by both parties; and both branches of government's support; that would have been a much stronger signal to the markets and to the world. So I think that was the better approach. Incidentally, the terms of the deal I think would have been superior as well.

But the second thing is that the Treasury—and again, I will hearken back to when I ran the Exchange Stabilization Fund—has always been reluctant to use the Exchange Stabilization Fund for longer-term credits. It is perfectly legal. The President has the authority to do it. But it has only been done in very limited circumstances in the past. The main reason is that you don't want to set a precedent where every country in the world seeks the same long-term money from the Exchange Stabilization Fund. The Treasury, I think, felt on this occasion that it had to extend these credits because the legislative package wasn't going to make it. But I think that the original proposal was far superior on those grounds as well as the bipartisan, bicameral grounds and that is why they tried it in the first instance.

Chairman GILMAN. Mr. Bergsten, does the President propose to use the full Fund?

Mr. BERGSTEN. No, not the full Fund, as I understand it. I am not privy now to the details of how much is in the Fund. It is, as I said, a revolving fund; I know from the past that the Fund is frequently depleted and then replenished. It can be replenished instantaneously by what amounts to a swap between the Treasury and the Fed, and in addition, it can augment its resources by $30 billion or so by activating the international swap network that the United States has with all of the other major industrial countries. So in this instance, the President is only using a portion of the ESF current resources and only a small fraction of its potential availability if needed to defend the dollar.

Chairman GILMAN. Mr. Sweeney, did you want to comment?

Mr. SWEENEY. Well, as to the question as to why President Clinton came to Congress first when he could have done this unilaterally, I think that one of the aspects of this whole crisis that comes through in the testimony of the different administration officials have given in the last 2 weeks is that they have lingering doubts themselves about whether this bailout is actually going to work in the long term. They have doubts as to whether once the United States provides these loan guarantees and allows Mexico to get past this imminent debt crisis and buy some time so that it can restructure and reschedule yet again, they have doubts whether this will actually work in the future, whether the Mexican crisis will actually be resolved, and I think there was a certain political element there in wanting to share the risks, so to speak.

Chairman GILMAN. Anyone else want to comment?

Mr. FAUX. I don't really know the answer to that, but my guess is that when they first went to the IMF and the other international bodies, they were told no. And then when it became clear that the

initial package might accommodate the Mexican Government need to turn over its debt, finally with a gun to everyone's head, the IMF changed its mind.

But I think it is important to understand that—while Dr. Bergsten is the expert on where this money is and how much is in there—it is not like it comes out of thin air. There is credit somewhere in this game, credit by the United States of America that is being pledged. It may be redeemed. It may not.

Mr. Burton—I think it was—raised the question in a different way in his statement when he said that he thought that this Fund was dedicated to protecting the U.S. dollar. I think that is right, and it is a little scary to understand now that the notion of what protects the U.S. dollar is now extended to the Mexican peso. The argument is being used that we have to keep the peso up in order to keep the dollar up. Well, this is very treacherous terrain and I think that this needs a lot of examination.

Chairman GILMAN. Thank you.

Did Mr. Sweeney want to comment?

Mr. SWEENEY. I did want to make one more comment.

Dr. Bergsten said in his earlier testimony that the use of the Emergency Stabilization Fund would pose no threat to U.S. taxpayers unless Mexico defaults, and that is one of my great concerns, whether Mexico will, indeed, default at some point in the future.

I fear that by bailing them out now—and I think leveraging, what was mentioned earlier about the political fragility of Mexico today. But I nonetheless fear that by bailing them out now we are not helping the Mexicans solve their problems, we are merely postponing the crisis to a final reckoning at a higher cost at some point in the future.

The Brady plan was supposed to solve this problem in 1990, and yet here we are again 4 years later with basically the same kind of debt problem, only this time banks aren't holding the bag, private investors are.

Chairman GILMAN. Thank you. Some of us have been concerned about the lack of international involvement, that we are the only one up front on this, and of course it is our nearest neighbor. But shouldn't there be other countries involved and are there any other countries involved in this proposed plan? I address that to the entire panel.

Mr. BERGSTEN. There are now, Mr. Chairman. I suggested already that I thought the original proposal for legislation was superior, and I still take that view. But its one shortcoming was exactly what you say, the lack of international participation. The United States would have been by far the overwhelming provider of the credits and the guarantees.

With the passage of a few weeks and the recognition that the original U.S. proposal was not going to succeed, there now has been an increased indication of participation by other countries. Part of that occurs through the IMF, which of course is internationally owned; we are the largest shareholder, but less than 20 percent. Secondly, participation comes through the BIS package, which has now been doubled from $5 to $10 billion as part of the package.

Interestingly, four of the Latin American countries, fearing the overflow effect on them, have put up $1 billion of support; the Canadians have come in with $1 billion. So one virtue of the current package, as opposed to the original, is that it is more widely dispersed.

I think there is a big issue here. I think other countries, particularly G–7 countries, have not been quick enough to recognize their responsibility, the fact that this is a global, systemic problem, and I hope that does continue to be corrected.

Chairman GILMAN. Thank you. Mr. Hamilton.

Mr. HAMILTON. Thank you very much, Mr. Chairman.

First, I just want to say that in response to the criticisms from members earlier today about the administration not being here—a criticism I think that is quite valid—Secretary Rubin has appeared this morning before the Democratic Caucus. He is scheduled to appear at 1:30 before the Republican Conference.

Mr. BURTON. Oh, great.

Mr. HAMILTON. He is also trying to set up briefings with the House Banking and Senate Banking Committees this afternoon, and I have assurance that they will be back on the Hill next week. So the administration is making a little progress in trying to respond to your complaints, and of course Secretary Rubin is now being asked to appear in about a dozen different places all at one time. So he has his problems in selecting the forum.

While I want to know how much this is going to cost the American taxpayer, one of the reasons Members of Congress get confused is because witnesses give us such extraordinary diversity in their testimony. Mr. Sweeney, you are on record, I think, as saying it is going to cost the American taxpayer $40 billion.

Mr. SWEENEY. That is my opinion of what it could cost if Mexico defaults on its obligation, which Mr. Bergsten says is not going to happen, but I think it may happen.

Mr. HAMILTON. So your testimony is that the American taxpayer is going to lose $40 billion?

Mr. SWEENEY. I think there is a strong potential for that, yes, sir.

Mr. HAMILTON. And Mr. Bergsten says we might make money on the deal.

Mr. BERGSTEN. I will bet him a steak dinner.

Mr. HAMILTON. I don't know where the other two witnesses are, but what a gap. I mean, no wonder we find it hard to reach a conclusion on these matters.

Mr. BERGSTEN. You just have to put probabilities on the forecasts.

Mr. HAMILTON. Well, look, you have a choice here between two things. Either you do something or you do nothing. And several of you are arguing we should do nothing. Mr. Sweeney, that is clearly your argument.

Mr. SWEENEY. Yes, sir, I think that is the best solution.

Mr. HAMILTON. Mr. Faux, that your argument, too?

Mr. FAUX. I would not have voted for the package.

Mr. HAMILTON. You would do nothing.

Mr. FAUX. If it was the package or nothing, it would be nothing, yes.

Mr. HAMILTON. OK. Ms. Baer, how would you come down on that question? Mr. Bergsten's position is clear, I think.

Ms. BAER. Yes. And my position should be very clear as well. I think there is a high degree of probability that this package will, indeed, avert—will restimulate capital markets to their normal functioning and make it unnecessary for the U.S. taxpayer to assume any liabilities from a default.

Mr. HAMILTON. What is your judgment—I ask this to any of you who want to respond. How imminent was the default by the Mexican Government? Was the President right when he said things were just about ready to go to hell in a hand basket in Mexico?

Mr. SWEENEY. I had a bet with my brother in New York who is a banker in New York and has a lot of money riding on this in Mexico, at least the bank he works with, that he was betting that it was going to be today that they would declare a default. I bet him that it would probably be tomorrow.

Mr. HAMILTON. So it was imminent.

Mr. SWEENEY. There is a debt crisis. That is why I disagree. He keeps calling it a liquidity shortage.

Mr. HAMILTON. I understand that is a fundamental difference, too, between the two of you. A default occurs. What is any big deal with Mexico defaulting? Is that any skin off of my back?

Mr. BERGSTEN. Yes, it is a great deal of skin off your back, because it would have enormously adverse effects on the Mexican economy, both in the short and longer run.

There have been references made to the debt crisis of the 1980's. As I said, my colleague, Dr. Cline, has produced a comprehensive study of that, including what lessons we ought to have learned from it. One of the lessons is that, for all of the talk of bailouts and the like, the strategy throughout the 1980's was to try to avoid default by the debtor countries and to maintain the solutions as market-related as possible, and that was done pretty successfully——

Mr. HAMILTON. What I want to hear from the panel is——

Mr. BERGSTEN [continuing]. With the goal of avoiding a rupture between the countries involved, including probably Mexico, and the private financial markets.

Mr. HAMILTON. But, Fred, what happens if Mexico defaults? Do Hoosiers lose jobs?

Mr. BERGSTEN. Yes.

Mr. HAMILTON. What happens in the default?

Mr. BERGSTEN. The immediate spinout of a default would be a total drying up of new capital coming into Mexico and further flight capital out of Mexico to the extent people could get it out because there would probably be comprehensive exchange controls; Mexicans couldn't possibly run a trade deficit and finance it with external capital, meaning that our exports would plummet. Their whole economy, because of the drying up of liquidity, would almost certainly crash into a recession.

Mr. HAMILTON. Mr. Sweeney, what do you think would happen?

Mr. SWEENEY. I think that everything that Dr. Bergsten is saying could possibly happen, but he is overlooking one thing. If the Mexicans face a default situation, I don't think they are going to sit on their hands and let the house of cards fall down around them. I think they are going to be compelled to seek a market solu-

tion with their creditors on Wall Street and in other centers and they are going to do so very quickly. So I don't think that we are going to see the total collapse of the Mexico economy.

What I think we will see is a market-driven restructuring or rescheduling of Mexico's loans without U.S. Government control. And that is our position at Heritage. The U.S. Government should not be involved in bailing out the private sector for bad investment decisions and bad policies.

Mr. HAMILTON. Dr. Bergsten, I would like you to address that. We had an article in the Post this morning talking about creative destruction, letting the market work and giving Mexico a wake-up call so that they can straighten out these economic problems. What is wrong with that?

Mr. BERGSTEN. Well, as you know I am a very market-oriented economist, and I basically believe——

Mr. HAMILTON. Yes, but you are arguing for intervention here.

Mr. BERGSTEN. Government actions is warranted in the case of a potential default, an imposition of exchange controls, or a currency going inconvertible in an economy that I argue is fundamentally sound and faces only a short-term liquidity problem. That is the difference.

Mr. HAMILTON. The real difference between the two of you is the way you analyze the strength or lack of strength, as it were, of the Mexican economy.

Mr. BERGSTEN. In some sense, this is a replay of the debate of the 1980's. When the debt crisis hit in 1982, the immediate question was, is this a liquidity problem or a longer-term solvency problem? It turned out in 1982 to be somewhere in the middle. Arguably, the Mexicans would have made out all right through the debt crisis period had the oil price not collapsed in 1986 and had they not opted for the short-term solutions of the early part of the 1980's. But that is in a sense irrelevant, because Mexican economic policy and performance today is light years from where it was in 1982. Note that even Mr. Sweeney, in a series of asides during his original comments, paid great tribute to the Mexican economic reforms over this period. I simply say they have gone further and the country has a solid economic base.

Mr. HAMILTON. Mr. Faux was arguing, if I understood him correctly, I may not have, that one result of all of this is we become the lender of last resort. Is that one of the arguments?

Mr. FAUX. That is right, yes. Somewhat more than that I think. I think we have taken even more responsibility than that for the Mexican financial system.

Mr. HAMILTON. OK. What about that?

Mr. BERGSTEN. I have to admit I smiled when Mr. Faux said that. I put myself in the position of the Finance Minister of Brazil, Argentina, or some other country watching this debate in the United States for the last 3 weeks and just thinking how comforted I would have been at the thought that the Americans were going to come charging to the rescue! I mean, this is not exactly a situation to which a country would want to expose itself. If anything, the Mexican crisis galvanized these countries' resolve to take action on their own, as they have done. The Argentines equally have already taken a series of measures.

Mr. HAMILTON. If I understand Mr. Rubin correctly, he is saying that Mexico is a special case because of the considerable U.S. economic stake there, because it is a prototype economy. Prototype, I'm not sure what that means, but prototype economy. What is the risk we become the lender of last resort here?

Mr. BERGSTEN. I think——

Mr. FAUX. I think there is no risk. We have already decided to do that.

Mr. HAMILTON. We are already doing that?

Mr. FAUX. That is right. We are already doing it.

I would like to answer that and say something about this market situation. Here we are, glibly talking about market-oriented economics, and yet when the market makes a decision like this, we jump in and bail it out.

Now, I am not in principle against the government jumping in and bailing out markets when they fail, but I think we ought to be honest about this. And not keep telling ourselves that the market system is going to solve our problems, and yet every time it starts to crack, we jump in and bail it out. Either there is risk here or there is not.

Look at what has happened at the IMF: they said no last week and now when it became more of a crisis, when it looked like the Congress was not going to pass this package, they said yes. I would expect that before a default there would be a number of lenders who say no, but when faced with that prospect would say yes.

Secondly, the basic fundamentals of the Mexican economy that we have been talking about are right. I think that the Mexican economy has got a lot going for it. Then why, in the real world, would someone who was going to invest in a factory in Mexico in order to produce goods, sell back here or sell someplace else for export, not invest in Mexico next week after this default? Now——

Mr. BERGSTEN. Because the Mexican financial system had imploded——

Mr. FAUX. Wait a minute. They still have factories, they still have workers who are highly skilled; they have workers in factories in Mexico that are producing at the productivity level of the United States and getting paid 10 percent of what U.S. wages are. So that fundamental asset doesn't go away. As a matter of fact, an American investor, or a private investor in Mexico, will be better off because the dollar will be worth more. Now, that is not a happy story, but it is not a story where Mexico somehow implodes, to use these dramatic words, and goes away. Default is a problem, and default——

Mr. HAMILTON. My time is up. Your analysis to the economy of Mexico is similar to Mr. Bergsten's.

Mr. FAUX. I think the economy is fundamentally strong. It has a lot of assets to it.

Mr. BERGSTEN. Could I just pick up with three points here quickly, because they are very important.

One, Mr. Faux continues to say there is little or no relationship between the financial markets and the real economy. Wish it were so. But if credit dries up and if a country is cutoff from world financial markets, that will deter an investor, foreign or domestic, from putting up a new plant there because he would be isolated from the

world economy and financial markets for a substantial period of time, and that can very significantly affect his decision.

Second, Mr. Faux tends to paint a picture of all of these countries around the world just waiting for the United States or somebody to come in and bail them out, as if that is a wonderful scenario.

That is the last thing any of these countries want. The Mexicans don't welcome the current situation; they hate it. It is not as if other countries will get in line eagerly if we show ourselves to be lender of last resort in hopes that they can get it next.

But let me address your question of the lender of last resort. Let's be clear. The world economy has to have a lender of last resort. The U.S. economy has to have a lender of last resort. We have it. It is called the Federal Reserve. It does bail out people who get in trouble when not doing so could cause system-wide economic difficulties. It has done it time and again. If it had done it in the thirties, we might not have had the Great Depression.

We know we must have a lender of last resort. We don't like it; we always debate its terms, but we have to have it. The world economy is today so integrated and interdependent that the world economy must have a lender of last resort. I take that as given.

A fair question is, who should it be? I don't believe it should be the United States; I believe it should be the international community working through the IMF. Unfortunately, we are not quite to that stage. The United States, because it has been the biggest guy on the block, and the dollar as the key currency, has done that historically in the last 50 years. We have been phasing out of it, and this deal, incidentally, is a step in that transmigration to an international lender of last resort. But we must have it. Let's not deny that. That would simply be sticking our heads in the sand.

Mr. FAUX. Can I answer that?

Chairman GILMAN. The gentleman's time has expired. Mr. Roth.

Mr. ROTH. Thank you, Mr. Chairman. I want to follow up on Mr. Hamilton's question, because I think he is hitting at something that I think is really key here for us.

Dr. Bergsten, you know I appreciate the testimony that you have given us in the past, and I admire you a great deal. So I am asking this question in a friendly way. You say you are a market economist. We Republicans always say let the markets decide, the markets are correct. Now, what do the markets know that we don't know, or what do you know that the markets don't know? The markets have spoken strongly here, emphatically, and they have said no.

Mr. BERGSTEN. The markets have the well-known herd mentality. As I mentioned, until less than a year ago, the markets were saying yes, yes, yes, resoundingly yes in the case of Mexico. They were pouring so much money into Mexico, the Mexicans couldn't handle it all. They were trying to pawn it off and sterilize it. In fact, one of the reasons the peso became overvalued was all that foreign demand for pesos. If you want to ask, where did the overvalued peso come from? The answer, in part, would be it came from these wonderful folks in the market.

Mr. ROTH. You know I was in business before I came to Congress, and I know you can make a lot of money betting against a

herd, but the herd isn't that stupid that they are all going to go in one direction. There has got to be more to it than that.

The reason I say that is this: I have been following this, and the Mexican economy you say is basically strong. Then if that is the case, why can't they cover these bonds at 20 and 27 percent. They were making as much as 51 percent. There has got to be something here that is deeper than just the herd mentality.

Mr. BERGSTEN. No, no. Right now the reason interest rates shot up is because of this liquidity crisis. The reason that an investor would insist on 57 or 21 percent interest in Mexico was that he was afraid that when he came to cash in that bond 2 or 3 months from now the peso would be inconvertible. He couldn't get back into dollars. That is why there is, indeed, a liquidity crisis. That is why this package was necessary. But that is a different point from whether or not the fundamental underlying economics are strong.

Mr. ROTH. I have agreed with you in the past. I think you are a brilliant person. I will have to say in this case I do not follow that logic, because from my business sense and from my experience, that doesn't follow.

I would like to have Mr. Sweeney give me his perspective on this.

Mr. SWEENEY. Well, touching on a couple of comments that have been said here at the table today, one of the things that Dr. Bergsten pointed out was the need for long-term direct investment in the Mexican economy. That is one of the things that all of us who follow Mexico and the rest of Latin America have seen with concern in Mexico, that increases in direct foreign investment in the Mexican economy have not, in my opinion, at least, reflected the magnificent advances that the Mexican economy has made in terms of its modernization in the last few years, and I think what you are seeing there is that the market is seeing that something is not exactly right.

Mr. ROTH. I appreciate that. But the chairman will only give me so much time and I want to get to this question now. I was here for the Baker plan and the Brady plan. I know those things didn't work because America is not the lender of last resort. You see, America is the lender of first resort. We are the easiest. That is why they are here at the door; that is why we have to say no.

Mr. SWEENEY. I would say your interpretation is correct. Whenever something happens, they come to America, they come to Washington, they want a bailout. And this has become a habit in Mexico. This is my particular concern. The Zedillo emergency program does not address the problem. They are relying on the bailout to restore investor confidence and I believe that investor confidence will not be restored by this bailout. There are deeper problems that need to be addressed in Mexico.

Mr. ROTH. Mr. Chairman, I know my time has expired, but if I could get—I am trying.

Chairman GILMAN. The gentleman will limit himself to another question.

Mr. ROTH. Thank you.

What I would like to have from each one of our friends here is to give this committee a prognosis of what is going to happen here. What is going to be the fallout from the President's action? The reason I would like to do that, because I keep notes, Mr. Chairman,

on these hearings that we have had over the Brady plan and you get, you know, you get—these intellectuals have a tremendous advantage, because they can say anything and 2 days later nobody remembers, 2 years later nobody remembers. It is like the talk shows on Sunday morning. I mean, I love to be on those things because I can say anything I want. A week from now nobody remembers. But in Congress they always remember, because you got these elections coming up, and they got voting records. So if I could get a prognosis from each one of these members, that would be great.

Mr. BERGSTEN. Let me just say to my good friend, Mr. Roth, he doesn't understand the market for ideas because in our business we are reminded of our predictions, and if they were wrong, we lose some credibility the next time. Presumably, the reason Mr. Roth said all of those nice things about me is that his record that he has kept meticulously over the years shows all of the accurate predictions I have made.

Mr. ROTH. You came up to me and talked to me before the hearing.

Mr. BERGSTEN. I want to just ask you, if I could, Mr. Roth, one question, because it is critical on this question of a short-term, long-term problem. Are you not aware from your business experience, are you not aware of any firm, which is a solid, competitive, well-managed firm, which runs into a cash crunch and can't pay the bills 30 days out? ROTH. And if they do, they can always get money. There is no such thing as a good company not getting financing. The companies that don't get financing are the ones that don't have money. That is the problem.

I will tell you one thing. We have got some brilliant people, but there are no more brilliant people than the people in the commercial industry. You know why? Because when you are sitting there at the bank borrowing money, it is your bank. When you spend it, it is your bank. It is like investing in the stock market.

When I was a kid I had all kinds of stocks I invested in, and, oh, I was making money here and losing money there on paper. And then when I got out of school, I started putting some money into the stock market. What a difference. And that is the difference we got here. It is easy to talk about it, but once you got your money on the line, it is way different.

Chairman GILMAN. The gentleman's time has expired. Mr. Menendez.

Mr. MENENDEZ. Thank you, Mr. Chairman. Mr. Chairman, do I start with a green light? I don't want to start with a red light. Thank you.

Mr. Sweeney, I just want to—I heard your whole statement, I read it as well, and I just want to go back to a different issue for a moment. Did the Heritage Foundation support NAFTA?

Mr. SWEENEY. Oh, yes. We do and we still do. Your confusing NAFTA with this crisis is a mistake.

Mr. MENENDEZ. Don't you believe, though, that in part, part of the speculative environment that is created and for which investors went is based upon that?

Mr. SWEENEY. I believe that the Mexican crisis happened because they don't have their economic fundamentals right and be-

cause of politically driven monetary policy manipulation last year. It has nothing to do with NAFTA. NAFTA in its first year has been a spectacular success and it ought to continue being as successful as it was in its first year.

Mr. MENENDEZ. Those underlying policies that you suggest are wrong were clearly wrong during and prior to NAFTA. Wouldn't you have balked at at least making sure that there were conditions, so that in fact those conditions that you describe——

Mr. SWEENEY. No, I would not have balked at approving NAFTA in its present form. I think it is an excellent precedent. It is an excellent document. It is an excellent treaty for creating a hemispheric free trade era.

What I would have done is I would have insisted far more strongly that the Mexicans continue with the process of economic reform. It is one of the things that Al pointed out, that reform is proceeding very slowly in Mexico. The easy reforms have already been done. The difficult reforms, the constitutional reforms, laws, the establishment of rules of law, property rights, a whole series of issues in Mexico which have strong underlining political connotations and which the Mexican and ruling elites are resisting. The same problem is cropping up all over Latin America.

Mr. MENENDEZ. Clearly, then, you worked on the supposition—and those who supported that proposal—that Mexico would continue to move in the direction that you now criticize. It lacks movement.

Mr. SWEENEY. Well, my concern is that by bailing them out we are facilitating the forward—we are facilitating the lack of forward momentum.

Mr. MENENDEZ. Dr. Bergsten, I listened to your indictment of the present U.S. policy, congressional leadership and all Members of the House, and I don't take that lightly. Let me just suggest that there are many of us who believe that there is an indictment of those who are free marketers and then when it comes time for risk, which is part of a free market decision—you know, people are going back to Tesobonos, investors are going back to Tesobonos because of U.S. intervention, not because of something Mexico has done.

The fact of the matter is I think that in capitalism, failure is just as important as success, and if you take away the very calculus of risk and you have no consequences thereof, then you really undermine free market principles. So I am seriously concerned about putting a stack of chips on a roulette table. I know that there is great risk. Also, there are great benefits if I win.

Clearly, Mexico is paying very high yields. And as a result of this whole incident, it is interesting to see today's article in the "Business Daily" of the *New York Times* about the whole question of emerging markets and those investors looking at countries with relatively low reserves of foreign currencies and who have extreme problems with current account deficits.

My point is: don't we have a part in situations which we have now created that we must now respond to, we have interest in responding to. Haven't we created this process by which we are sucked into having to respond, because we have been dealing in a speculative environment, which is fine in the free market, but which has its risks, and risk is part of a determinative factor in

making a free market decision. And then you seek government to rescue those free market decisions. That is a problem with what I have in your indictment of all of us here.

Mr. BERGSTEN. Well, that is fair enough. A two-part answer.

First, I fully agree that in virtually all cases you let the market dictate, including bankruptcies and failures; that is absolutely right. There is one case where you don't want to do that and where a lender of last resort comes into play. That is a situation where the impact on the individual in bankruptcy has such a widespread effect on the system as a whole, the national economy, or in this case the world economy, that the externalities—to use the economists' term—are just too costly to permit it. The colloquial term is "too big to fail." That is what our Fed has done vis-a-vis banks: it won't let Citibank fail. It doesn't deny your basic principle. Your basic principle applies in 99.99 percent of all cases. But there are cases where the bankruptcy would be so extensive in its effect that it pays, though we hold our nose to do it, to bail them out and avoid incurring the larger costs. That is the answer I would give you, and I think it is a correct answer.

Now, second, you raise a broader question, which is also correct, about the capital flows. I am quite sure one implication of this crisis is going to be that many developing countries around the world are going to reassess whether they want to continue the capital market liberalization of the last decade. They are going to observe what has happened, first noting that the huge inflows, which, as I say, Mexico was getting as recently as a year ago, weren't such an unmitigated virtue, and then looks at what happened with the huge overflow. This is a teeter-totter with these private markets. I am sure many countries, as three or four have already done over the last year, are going to resist the big inflows and prepare themselves to defend against the big outflows. That will mean less openness of capital markets.

That is not something we like philosophically. It may, in fact, from this experience prove to be a prudent course for many countries. I suspect we will have fewer of these in the future, simply because there won't be as much private money to slosh in and out.

Mr. MENENDEZ. Maybe we will see the reemergence of good old T-bills and blue chip stocks.

If I may, one last question, Mr. Chairman. Dr. Baer, you suggested, you talked about an important point, that was part of all of this process on conditionality, and isn't it—and I understand that you said you can't have it all, all foreign policy interests at one time. I think that is a good point.

However, there are those who say there should be no conditionality, even though I remember that Israel's loan guarantee had a political conditionality as it relates to settlements and those that would not be permitted, or that the United States would deduct its guarantees to the extent that—so we have a precedent for creating conditions.

The fact of the matter is, isn't it in terms of peaceful diplomacy that the use of international opinion and our broad range of economic tools such as embargoes and/or in this case loan guarantees or similarly structured packages, isn't it appropriate for the United States to maybe not have all that it desires to accomplish, but isn't

it appropriate for the United States to use as a form of peaceful diplomacy that economic opportunity in order to have some conditionality, not only on use and economic conditions, but possibly on some other condition?

Thank you, Mr. Chairman.

Ms. BAER. I think it is appropriate to use every public opinion forum that you possibly can to promote the objectives that you are trying to accomplish.

In the case of the objectives that you are most concerned with, I have an enormous amount of sympathy for those objectives. I was in Cuba a few years ago and I have to say it was one of probably the most disturbing countries I have ever visited. So I have complete sympathy with the cause you are espousing.

My concern is one of principle and of practice. In practice, what we have begun to see are a whole series of policy decisions of enormous consequence, whether it be the fact—renewal of the fast track authority to negotiate free trade agreements in 1991, whether it be the North American Free Trade Agreement in 1993, or whether it be GATT, or whether it be a whole host of other very important policy decisions, or upcoming renewal of fast track authority for a free trade agreement, to pursue a free trade agreement with Chile, and we are creating a policy bottleneck. I think that it threatens to become dysfunctional.

There is a time when you hit the point of diminishing returns in terms of what you are able to accomplish in your own policy objectives and the primary goal of promoting a free trade agreement with Chile or a free trade agreement with Mexico. My concern is that we have reached that bottleneck, and that that bottleneck does not serve either your objectives or the objectives of moving forward the original policy that was put on the table to begin with.

Chairman GILMAN. The gentleman's time has expired. Mr. Burton.

Mr. BURTON. Assuming you were just talking about Cuba, we have a policy on Cuba. We have an embargo and if we are going to loan Mexico money or give them a loan guarantee, it seems to follow that we would like for them to at least be sympathetic to our views, especially for putting up a large sum of taxpayers' money. As Chairman of that subcommittee, I want that guy out of there. That is the number one goal of that subcommittee, get him out of there however we get him out in the next couple of years.

Now, there is a divergence of opinion on the board, as Mr. Hamilton pointed out, between whether we are going to lose $40 billion or maybe make a little bit of money. And as Representatives of the people, it seems to me if we are going to err, we ought to err on the side of the taxpayer in this country, and there is a divergence of opinion.

Now, Mr. Bergsten said to Mr. Roth that, you know, he had made an awful lot of great decisions and Mr. Roth ought to acknowledge those. And I understand the economists in this country, there is no limit to their confidence. However, I remember, as I recall, that Mr. Bergsten thought that if we lowered the dollar, it would dramatically lessen the U.S. trade deficit with Japan, and I don't think that worked, and as I recall, under the Carter administration, under his watch, the Latin American debt crisis started. So

I am not criticizing you because everybody is entitled to make a mistake or two, but you are not infallible. I just thought I would point that out.

Mr. BERGSTEN. May I defend myself?

Mr. BURTON. Well, in a minute.

I would also like to say that assuming that you are correct, Mr. Bergsten, those who are in favor of this, will this not buy time for American investors who felt like they were about to take it on the chin to extricate themselves from Mexico if they think that this thing isn't going to be resolved over the long term? And if there is no risk, if there is no great risk, then why didn't the private banks and financial institutions rush in to help bail this out instead of the Federal Government?

You also said that there ought to be a lender of last resort, and I am covering a lot of ground here, and you alluded to the IMF. You know, we put up over 18 percent of the total funds of the IMF and the World Bank. I think we put up more than that. So the United States, one way or the other, by hook or by crook, is going to be the lender of last resort, and it really kind of bothers me that doesn't hold these governments more accountable.

And the last thing I would like to comment on, and I think this is very important, it is kind of damning, what Mr. Sweeney said in his comments, and I want to quote these, because I think it is very important. I don't know how you defend this. It says that since 1988, Mexico's total foreign debt, public and private, short term and long term, has increased to about $160 billion, of which $71.3 billion is due for payment this year, according to financial analysts at First Chicago in New York.

In congressional hearings last week, Mexico's total foreign debts due this year were estimated to be $81 billion. Assuming that First Chicago's lower estimate is accurate, then about 44.5 percent of Mexico's total foreign debt matures this year. Moreover, the foreign debt due in 1995, 60 percent greater than Mexico's total exports in 1993, while the total foreign debt of $160 billion is equivalent to nearly $67 percent of their GNP.

Man, this sure sounds like quicksand to me and I don't see how this program is going to bail them out of this, unless there is a complete restructuring of the way they do business down there. So I would just like for you, gentlemen and ladies, to comment on this, and I know I covered a lot of ground, and you are entitled to defend yourself, Mr. Bergsten.

Mr. BERGSTEN. Let me give quick answers in the inverse order.

I think you are right, and Mr. Sweeney is right, that the Mexicans made a policy error in their debt financing strategy. They did permit too much cumulation of their debt at the short-term end of the spectrum that underlay this liquidity crisis. There is too much coming due in the short run. Interestingly, Argentina and some of the other countries did it differently. They have a longer-term debt profile; they do not have that same liquidity crisis. I think that was a Mexican error. They did this debt stretch-out before—so it is related, but it is a separate instance.

The other point I wanted to make, though, is that the Mexican debt ratios—debt to GDP, debt to exports—are much, much better today than they were in 1982 when the debt crisis broke, and in

fact, at least before you rejiggered the GDP because the exchange rate changed, their ratios were well within the normal danger signals, again, reinforcing the point that it is a short-term liquidity problem rather than an underlying solvency problem. I would come back to that.

Second, on your question about the IMF and U.S. participation, you are absolutely right. I would simply say, better to have the lender of last resort, an operation in which the U.S. share is 18 percent rather than 100 percent. I would rather have it shared.

Third, why doesn't the private capital come in if the situation is good? And Mr. Roth said the same thing. The basic difference is collateralization. Private lenders, I think, would no doubt extend credit to Mexico if the Mexicans would put up first claim on their oil earnings the way they are doing to the U.S. Government. They won't do that for a private holder because they would get into the morass of determining which private holder. If they do it for one, why not the others?

But the U.S. Government is able to get that condition.

Mr. BURTON. Let me interrupt you. I don't want to take too much time, Mr. Chairman. But it boggles my mind to think if the bottom dropped out of the Mexican economy that they are going to give us their oil monies, the monies from their oil reserves as they are sold. I just—I think that is a bogus argument; I just don't believe that is going to happen.

I think that, you know, one of the things that I wanted to see done was to have them put up hard currency or instruments, financial instruments that we could put in a bank that were negotiable to the tune of $2½ to $3 billion. They had those; they could have done it and they chose not to. So I think that is a bogus argument on those oil monies.

Mr. BERGSTEN. Well, I haven't seen the text of the agreements that have been worked out, but the way they have been presented, the administration suggests that it has an absolutely firm legal commitment from the Mexicans, and indeed from the purchasers of Mexican oil, to channel their payments directly to the New York Federal Reserve Bank. This has been done on other occasions. If you hypothesize that the Mexicans would violate a fundamental treaty commitment to the United States, I guess you can be skeptical of it; I guess I would have a little more faith.

Finally, the decline of the dollar in the mid-1980's took the U.S. global current account deficit from almost 4 percent of our GDP in 1986 to less than 1 percent in 1991. As no less an expert on this issue than Congressman Gephardt said at the time, our trade deficit problem is over—except for Japan. Since then, other things have happened, but it did work.

Chairman GILMAN. The time of the gentleman has expired. I might add that we have three members waiting to question.

Mr. BURTON. I would like to have somebody else comment on that besides Mr. Bergsten. He takes the whole time.

Chairman GILMAN. Out of fairness to our remaining committee members, I would like to try to wind up before we have to go to vote and I will ask our committee members if they would be kind enough to be brief.

Mr. BROWN. I will. Thank you, Mr. Chairman.

I have heard, real quickly, I am amused by the comment of Mr. Sweeney about the spectacular success of NAFTA, the Heritage Foundation with the free trade fundamentalism can't seem to let go, with a year of trade position worsening, of more investment in Mexico because of the NAFTA stamp of approval from our Government, encouraging more investment there and the fact that exports have dried up, when a year ago or 2 years ago a lot of us talked about a side agreement on currency stabilization, but the Heritage Foundation didn't seem to see fit to ever discuss that. I know it is unfair, Mr. Sweeney, to say that and then not give you a chance to answer.

But, Dr. Baer, you said something about you can't achieve all of foreign policy aims in a bailout or in a trade agreement or something like that, yet—and I would like both you, Dr. Baer and Mr. Faux to comment on this—Dr. Faux, how can this rescue effort succeed when the same government is in place in Mexico? We are not requiring any kinds of change in the operation of this government, in their economic policies in terms of building a middle class, and in terms of their political corruptness. How can we with Salinas and Zedillo administrations that are responsible for getting Mexico into this mess in the first place, how does this agreement succeed when we don't see fundamental change from that administration for both Dr. Baer and Dr. Faux.

Ms. BAER. Unfortunately, we can't legislate the creation of the middle class in Mexico. Lord knows I wish we could. I think the only thing we can do to promote that long-term goal which we all share is to put in place the fundamentals that are going to permit Mexico to grow and increase its productivity over the long term.

As far as the corrupt Mexican Government, it has been mentioned several times today that the Mexican peso was supported in the last year for purely electoral reasons. Now, I happen to believe that Mexico is inevitably going to move to a greater transparency in its central bank reporting. I think that is already a given. It must occur, it should occur. But I don't really see any evidence to suggest that the overvalued peso was maintained in the last year simply for political or electoral reasons. Mr. Bergsten has already commented on the massive inflows of foreign capital that were forcing certain——

Mr. BROWN. I am sorry to interrupt, but you saw both the passage of NAFTA in the politics while NAFTA was being considered by this Congress and the Mexico Presidential—Mexican Presidential elections as having no bearing on their behavior in terms of dealing with their currency crisis over the last 24 months.

Ms. BAER. I think the Mexicans have maintained a very consistent policy toward the peso. Now in retrospect, perhaps an erroneous policy toward the peso, but certainly very consistent and a policy of maintaining it within a clearly defined mode has been in place far beyond the immediate political intimates that you are discussing, whether it be NAFTA or the elections. So I think that a decision was made to keep an overvalued peso to try to impact other—as a tool of anti-inflationary policy and I think that was far more fundamental to explaining why the Mexicans maintained an overvalued peso. They are not. I would suggest that they miscalculated. They miscalculated massively. But they believe that they

have the reserves to make investment grade and to then be able to devalue under more expeditious conditions.

I do not think that the peso was jiggered to impact NAFTA or the elections. That policy has just been too consistent over too great a period of time for that to be a convincing explanation.

Chairman GILMAN. The gentleman's time has expired. Mr. Rohrabacher.

Mr. FAUX. Mr. Chairman, please, could I just answer that? I was asked a question.

Chairman GILMAN. We are trying—I hate to cut you short. I have two members remaining to question. We have to go to the floor. Mr. Rohrabacher.

Mr. ROHRABACHER. Just one note, I think Mr. Sweeney pointed this out, but just to say that if you do believe in free trade, which I do, bailing out investors who have invested overseas is a great—it is a betrayal of your own working people, because you have, then, made investment overseas more attractive by taking away the risk that is involved, and thus people are investing overseas in risky situations rather than creating jobs here at home. And it totally negates the free trade benefits that you get when you have bailouts like this.

This bailout will negotiate NAFTA's benefits, because NAFTA, if—NAFTA's benefits to the American people. You know, we have supported NAFTA and did so because we thought it would support the American people. I just would like to say to Mr. Bergsten, and I just, just to say how long were you with the Carter administration?

Mr. BERGSTEN. The entire 4 years.

Mr. ROHRABACHER. And I didn't—your attacks to the Reagan years didn't pass me by without notice. I would just like to know, I do have a memory, and I do remember interest rates that went over 20 percent, and I do remember inflation rates that went over 20 percent under your watch. And I think that had the same economic conditions been maintained during the 1980's that we inherited from your policies, the situation would have been a lot worse. So I just thought I would say that.

We reversed some of those negative trends and some bad things happened. But had those negative trends that were created during your watch continued under the Reagan years, it would have been a lot worse. And with that said, I have to go vote.

Mr. BERGSTEN. That is fair. I was, however, charged with the international side. When I left office, we had a trade surplus. We were the world's largest creditor country. Our international position was very strong.

Mr. ROHRABACHER. That is fair, but I would tend to think that you probably agreed with the other policies as well, but we will have that for another day, have a longer discussion. Thank you.

Chairman GILMAN. I want to thank the panelists for their patience and for the generosity and time. The committee stands adjourned.

[Whereupon, at 12:40 p.m., the committee was adjourned subject to the call of the chair.]

APPENDIX

Full Committee Statement of
Congressman Benjamin A. Gilman
Hearing on the
Mexico Economic Crisis

I am very pleased to welcome our panel of expert witnesses who were all forced to do some late night editing of their prepared statements by the President's announcement yesterday of a revised plan to assist Mexico. Your flexibility and perseverance is much appreciated.

I am, however, very disapppointed that the Secretaries of State and Treasury declined to appear before us this morning. I am surprised that they would pass up this first opportunity to discuss this new plan with Congress after their joint press briefing yesterday afternoon.

I can only hope that this hearing will mark the beginning not the end of the dialogue between the Executive and the Legislative bracnhes on the future of our economic relations with Mexico.

The administration must explain this new proposal to the American people and to the Congress. With or without our authorization, the President and his cabinet officials must tell us in person why we should pledge billions of dollars in taxpayer funds for this purpose.

In utilizing our Treasury Department fund to protect the peso, we need to be certain that it still has sufficient resources to protect the dollar in any future monetary crisis. And we need to know what steps Mexico is taking to correct the policies and reform the institutions so as to prevent a reoccurence of this crisis.

In his appearance before the Banking Committee on January 25, Secretary of State Christopher indicated that Mexico's capacity to cooperate with us on a range of issues from narcotics trafficking and money laundering to the environment could be strained **without** the adoption of the loan guarantee plan. I would invite the Secretary to come before this committee in the future to explain how these worthwhile objectives can be acheived **with** the adoption of this new plan.

While I do not question the President's authority to implement this planmFortunately, we can get many of the answers to these and other questions from our panel of witnesses who have all written extensively about the economic crisis in Mexico.

Before recognizing our first witness, I would remind my colleagues that I will recognize those members present in order of seniority when our meeting begins. Thereafter, I will recognize members based on order of arrival. We will alternate our questioning between majority and minority members.

Do any other members have any opening statements?

Mr. Sweeney, would you start off first please, followed by Dr. Bergsten, Profesor Baer and Dr. Faux.

Statement of Rep. Robert Menendez (D-NJ)
on the Proposed $40 billion U.S. Loan Guarantee to Mexico
House Committee on International Relations

February 1, 1995

Mr. Chairman, for two years I have listened to my colleagues state in debates on the House floor that the House of Representatives is the greatest deliberative body in the world. But only in the last two days have I been truly surprised at the chilling lack of democracy in this cradle of democracy.

I am an elected representative. I am not here out of anybody's whim. I am not here because some dictator appointed me to serve in this great body. I am not here to rubber stamp any amendment, bill, or contract -- or anything else from either side of the aisle.

But I am here to represent the voters of the thirteenth district of New Jersey. With their votes they elected me as their voice in Congress. It is on their behalf and on behalf of the American people that I am speaking out today. It is on their behalf that I want to state loudly and clearly for the record that I stand staunchly opposed to the unilateral action by the Executive, in collaboration with the leadership of this House, to grant the Mexican government an unprecedented $47 billion bailout package.

Not a single congressional voice nor a single American voter will be heard on this banker bailout bill. It is a travesty of justice and I, for one, will not countenance this measure.

Last week, I wrote Chairman Gilman a letter expressing my serious concern that the Committee, in not holding open hearings, was rushing to judgment on this important matter, and that the House leadership, which had sought to bring this bill to the floor without opportunity for amendments, was trampling the legislative process. In that process, we as a Committee were in danger of gratuitously ceding jurisdiction to another committee at the very start of the 104th Congress.

As of Monday, the members of this Committee risked being denied the right as elected representatives of the American people to vote on the proposed Mexican bailout legislation or to offer any amendments. I was pleased and relieved when the Chairman announced last Friday that he would call a hearing on the Mexican bailout. Democracy carried the day, at least for the moment, and at least on that decision on that day.

But now, after the President's announcement yesterday, what purpose will this hearing serve, Mr. Chairman? What will the words that these reporters take down mean? Why are we here? To listen to ourselves? Or to deliberate? If in fact we are

deliberating, what beyond the printed text will come out of the hearings? The answer, sadly, is nothing much. I did not get elected to do nothing much at a committee hearing. I did not get elected to be unable to vote the will of my constituents on the Committees in which I serve or on the House floor.

The President announced yesterday that the U.S. is proposing to lend its "full faith and credit" to short term Mexican debt in order to salvage the Mexican economy. But will this $47 billion bailout really help? Even the most ardent NAFTA supporters have their doubts. Listen to avid NAFTA backer, Wesley Smith of the Heritage Foundation. [Quote]: "This takes real pressure off the Mexican Government to make substantives changes." James K. Glassman of the Washington Post agrees that the loan guarantees may provide a disincentive for reforms in Mexico. "Like parents who are too lenient with a rebellious adolescent, we may be encouraging misbehavior in the future." We may be helping the speculators who poured money into Mexico, but harming the prospects there for economic and political reform.

In another rush to judgment, we moved late in 1993 to pass the NAFTA. Many NAFTA supporters told me that if I were to vote for the NAFTA, I would be doing the right and the responsible thing. Now they claim that the right and responsible thing is to bail out Mexico and bail out NAFTA. That's what we have done. We have just bailed out NAFTA.

But before rushing to judgment on NAFTA, we should have anticipated the possibility of a peso devaluation. We should have regarded Mexico like the developing economy that it was -- not as the developed economy both of our governments portrayed.

With the passage of NAFTA without the appropriate safeguards, we created a speculative environment in which middle class investors, the mom and pop investors so vital to Wall Street brokers, were led to believe that investing some of their hard-earned life savings on mutual funds and pension funds investing in emerging Mexico was a safe bet. But billions of dollars later, we know it's not.

But never mind their losses, because what I say to you today carries no weight. We have been silenced. We have been shut out. We cannot use that most sacred of our rights -- the right to vote. It is a sad day for democracy in this great country. As I stated at the outset, only in the last two days have I been truly surprised and disappointed. The great voice of democracy has been silenced. The drama is over. Mexico will get her bailout package. But it is a sad day for America.

Testimony Before
the Committee on International Relations
U.S. House of Representatives
February 1, 1995

John Sweeney
Policy Analyst
Latin American Affairs
The Heritage Foundation

Yesterday, President Clinton invoked his executive authority to announce a unilateral resolution of the new Mexican debt crisis. The president abandoned his ill-advised efforts to win congressional approval of $40 billion in federal loan guarantees to bail out Mexico, when it became clear that Congress would reject his Mexican Stabilization Act. This new plan, like the original one, is an improvised hodge podge that will not solve the structural causes of the Mexican crisis. This new bail-out plan is bad policy, and it is bad politics. This obscene bail-out of Mexico and Wall Street will surely return to haunt President Clinton before he finishes his term in office. If Congress allows this bail-out to proceed unopposed, I believe that it will also return to haunt Congress two years from now, when the American people will hold their lawmakers accountable for this grotesque waste of U.S. taxpayer monies.

The original bail-out plan was a bad idea. This new plan is much worse. President Clinton has dropped any pretense of not dunning U.S. taxpayers for the cost of postponing a solvency crisis in Mexico for a few years more. Like the first plan, the numbers in this new bail-out scheme are changing daily. Indeed, when the White House issued its press release yesterday announcing the new bail-out proposal, the figures relating to the IMF's contributions were pencilled in, while in switzerland, officials of the Bank of International Settlements clarified that the BIS was "merely considering" the new Clinton bail-out scheme.

Yesterday, President Clinton's Plan B for Mexico was said to be worth $47.5 billion. This morning, the bail-out had risen to nearly $53 billion, discriminated as follows: $20 billion in commitments (not guarantees) from the U.S. Treasury's Exchange Stabilization Fund, which are to be used for short-term swaps, mid-term swaps and guarantees of long-term Mexican bonds. In addition, $17.8 billion in direct IMF loans, $10 billion in direct loans from the Bank for International Settlements,[1] $2 billion in short-term swaps from Canada and several Latin American countries, plus $3 billion in new loans from commercial banks.

It is worth noting some of more outrageous elements of the president's new bail-out plan. First, U.S. law authorizes President Clinton to tap the ESF for up to $36 billion if he wishes to expand the bail-out even more. Second, the IMF's announced

[1] Established in 1930, the Bank for International Settlements (BIS) was designed to foster cooperation among world central banks, to seek opportunities for development of financial activity among governments, and to serve as an agent involving the transfer of payments. Its offices are in Basel, Switzerland.

contribution is six times greater than Mexico is entitled to under IMF rules. IMF Director Michel Camdessus has said that he will ask members governments and central banks, including the U.S., of course, to contribute additional funds. Third, the $10 billion line of credit from the BIS is the largest loan ever made by that agency to a developing nation.

The Exchange Stabilization Fund was created in 1934. It has always been used to support the U.S. dollar internationally. Now, for the first time, the ESF will be used to stabilize the Mexican peso and a foreign government, and the money will come directly out of the pockets of U.S. taxpayers, confirming that President Clinton was misleading the American people and Congress when he pledged that the American people would not be paying for Mexico's bail-out. However, the $20 billion in the ESF are only part of the bill American taxpayers will financing out of their pockets. U.S. taxpayers will be underwriting part of the IMF loan, and it's not clear yet what the governments of the other countries participating in this bail-out with $10 billion through the BIS will demand from the United States as a quid pro quo. U.S. taxpayers could easily wind up shelling out more than $40 billion, particularly if the $53 billion pledged by President Clinton are not enough to end the Mexican crisis.

Will this massive bail-out of Mexico end the crisis and restore investor confidence? The answer is no. The U.S. bail-out will buy more time for Mexico to reschedule its foreign debts yet again, and to borrow still more money, constantly expanding its bloated foreign debt, to repay older debts as they come due. However, the bail-out will not correct the underlying structural causes of the Mexican crisis. The financial reasons for the peso's collapse have been described at length by Mr. Greenspan in testimony last week before the Senate Committee on Foreign Relations. However, the political causes of the peso's collapse have hardly been mentioned.

The political explanation of why the Mexican government refused to tighten its monetary policy last year, and why it drew down the Banco de Mexico's international reserves from $25 billion (end 1993) to about $6 billion when the peso was devalued in December, is that outgoing President Carlos Salinas de Gortari wanted to boost Ernesto Zedillo's chances of winning the presidential elections. Thus, Mexico's government spent the country's entire savings to keep the peso grossly overvalued throughout the year, reduce inflation even more, and facilitate billions of dollars in cheaply priced imports of U.S. consumer goods so that more Mexicans would vote for Zedillo on August 21. This is classic, irresponsible Latin American populism. It is also evidence that Mexico, despite its unquestionable economic advances of the past six years, has not progressed as far as its friends and supporters in the United States had been led to believe by the Mexicans, and by two U.S. administrations. Contrary to what Mexican Law stipulates, this crisis has shown that the Banco de Mexico is not an autonomous central bank, but an instrument of Mexican electoral politics.

President Salinas and his advisers gambled that confidence in Mexico would recover soon after the elections. I believe they were also confident that if their political gamble failed, the U.S. government would step in to bail out Mexico's government, as it has done frequently since Mexico declared a debt moratorium in 1982. According to the IMF's own data, Mexico in the past 12 years has refinanced, rescheduled or restructured its foreign debt at least six times, including the Baker Plan and the Brady Plan which was supposed to have ended the Mexican debt crisis in 1990. The U.S. government has been

directly involved in these reschedulings since the start of the debt crisis in 1982. The IMF has also been an active player since 1982. Between 1982 and 1992, Mexico rescheduled debts totaling $142 billion, obviously rescheduling the same debt more than once, and in the process increased its total foreign debt from $75 billion at the end of 1981 (45 percent of GDP), to $101 billion by the end of 1988 (57 percent of GDP). Yet, here we are again, four years later, with a much larger Mexican debt crisis about to explode in our faces.

Since 1988, Mexico's total foreign debt -- public and private, short-term and long-term -- has increased to about $160 billion, of which at least $71.3 billion is due for payment during 1995, according to financial analysts at First Chicago in New York. In congressional hearings last week, Mexico's total foreign debts due this year were estimated to be $81 billion. Assuming that First Chicago's lower estimate is accurate, then about 44.5 percent of Mexico's total foreign debt matures in 1995. Moreover, the foreign debt due in 1995 is 60 percent greater than Mexico's total exports in 1993, while the total foreign debt of $160 billion is equivalent to nearly 67 percent of Mexico's GNP since December's devaluation. Clearly, this is no transitory shortage of liquidity. When will this bad movie end? How many more Mexican bail-outs must American taxpayers suffer at the hands of irresponsible administrations in Washington, before America's leaders realize that the solution to Mexico's crisis is not in Washington, but in Mexico City?

The Mexican crisis needs a stronger free market cure than Mexico's ruling political, corporate and labor elites are willing to accept. The Heritage Foundation's recently published Index of Economic Freedom qualifies Mexico as one of the least free economies in the western hemisphere. Mexico has undergone a vast and highly positive transformation in the past decade, but Congress should note that the crisis has already compelled President Zedillo to announce a number of important reforms. For example, foreign investors will be allowed to own 100 percent of any Mexican financial institution, and the privatization of state enterprises is being relaunched. On the political front, President Zedillo is pushing much-needed political and electoral reforms that Salinas largely ignored. Nevertheless, Zedillo's plan relies too much on an IMF-style adjustment program -- consisting of devaluation, tax increases and wage restrictions, among other things -- that benefit exporters, but impoverish everyone else. To a great extent, the Mexican experience since 1982 has been a model for managing the debt crises and balance of payments problems of developing countries everywhere. However, this new crisis has been a shock to everyone who thought Mexico was doing everything right. Mr. Greenspan acknowledged as much in congressional hearings last week, when he made the following statement:

"...once the Mexican situation is stabilized, it will be important for the authorities of leading governments to examine closely the lessons to be learned from this latest episode in international finance, and to determine how to deal with similar emerging financial problems that have implications for the health of our free market-based international financial system." My translation of this statement into everyday words any American can understand is this: Something is seriously wrong here, this crisis should not have happened, and these continual bail-outs are not solving the problem.

The Mexican government is counting more on President Clinton's bail-out, than on fixing what is wrong with the Mexican economy. However, U.S. loan guarantees will not restore the Banco de Mexico's credibility, nor will a U.S. bail-out of Mexico restore investor confidence any time in the foreseeable future. Repairing the harm caused by last year's irresponsible, electorally motivated monetary policies is going to require years of hard work by the Mexicans. In the 1982 debt crisis, the hardest hit investors were the international commercial banks, who spent most of the 1980s restructuring their Latin American portfolios. This time around, the banks were out of harm's way. A new breed of investors has been burnt. These are the mutual funds and other institutional investors who amass the savings of millions of small investors, and then, presumably, invest these savings of millions of Americans with the appropriate prudence and caution. Even if Mexico manages to squeak out of this new debt crisis, this "second generation" of investors will not come rushing back into Mexico any time soon.

One of the Clinton administration's arguments in support of bailing out Mexico has been that, without a bail-out, the Mexican people will suffer great hardship. Let me assure you that the Mexican people are already suffering, and will continue to suffer for many years. Before December's devaluation, the average Mexican citizen's standard of living was between 30 percent and 40 percent lower than it was before the 1982 debt crisis. Before the Chiapas rebellion erupted on January 1, 1994, Mexico's gross national product was about $350 billion. The peso's devaluation, measured in U.S. dollars, literally evaporated more than 40 percent of Mexico's GNP. Today, Mexico's GNP is about $240 billion and it's still heading South. The Mexican people will not recover from this economic blow for at least a decade. For the next several years, at least, slower growth of the Mexican economy, higher inflation, higher interest rates and higher unemployment will compel a significant increase in the number of Mexican Illegal immigrants entering the United States. Administration arguments that U.S. exports and jobs will be hurt if the United States does not bail out Mexico are also spurious. The damage has already been done. No one has yet provided accurate estimates of the losses U.S. exporters will suffer as a result of the devaluation. However, if one assumes that between $10 billion and $15 billion in annual U.S. exports may be lost or simply unrealized due to depressed consumer demand in Mexico, some 200,000 to 300,000 U.S. jobs would suffer.

The new Mexican bail-out scheme, as described yesterday by the administration, is an affront to the American people and to Congress. Reliable opinion surveys show that more than 70 percent of the American people oppose any bail-out of Mexico. President Clinton abandoned his original proposal of $40 billion in loan guarantees, because Congress wisely refused to be rushed into making reckless decisions without weighing the merits of the Clinton plan, the extent of the Mexican crisis, and whether or not the bail-out would actually work. Now the president has invoked his executive authority to act unilaterally. According to news reports yesterday, Republican and Democratic leaders apparently have endorsed the president's new plan, because it will not require a congressional vote, and therefore will not involve any congressional accountability to the American people. This is

I fervently hope that Congress will continue to oppose this outrageous direct transfer of wealth from the pockets of American taxpayers, to the pockets of Mexico's

elites, and to the pockets of a privileged group of financial intermediaries who want their bad investment decisions forgiven at taxpayer expense. The Mexican crisis will not go away with this bail-out. Instead, Mexico will return to Washington a few years from now, seeking yet another and bigger bail-out. Meanwhile, the negative effects of the peso's collapse will be felt acutely in Mexico for many years, and to a far lesser extent in the United States as well. President Clinton's Mexican bail-out scheme would make the American people hostages of Mexico's corrupt electoral politics. Congress must not allow this to happen without vigorously opposing this presidential breach of responsibility to the American people.

In closing, supporters of the Mexican bail-out have warned that American leadership in the world is at stake, and that not facilitating more foreign loans to Mexico will cause a worldwide financial collapse analogous to the Chernobyl reactor meltdown in the former Soviet Union. I believe that any U.S. bail-out of Mexico will send the rest of the world the wrong signal. Bailing out Mexico will tell governments in emerging markets that bad policies based on short-term political imperatives will be forgiven, and it will send private investors the message that bad investment decisions will be bailed out at U.S. taxpayer expense. I also discount the alarmist assertions of those who believe that financial collapse will follow any denial of U.S. assistance to Mexico. Certainly, Mexico would announce a debt moratorium and probably impose exchange controls, but the Mexican government also would move quickly to apply the structural corrections the country needs. The truth is that no one knows for certain what would happen if Mexico is denied any U.S. loan assistance, and is compelled to seek a market solution to its new debt crisis. I believe there would be a sharp market correction, but nothing even close to the worldwide financial collapse claimed by the Clinton administration and Wall Street. Finally, I believe that Congress should look into the role played by the U.S. Federal Reserve in this crisis. The Federal Reserve is supposed to be independent from the Executive branch of government, and yet here we have a case where it is doing President Clinton's dirty work. The Mexican crisis has confirmed that the Banco de Mexico is a tool of Mexico's politicians. Can it be that the U.S. Federal Reserve has become a tool of White House politics and Wall Street?

THE PESO CRISIS AND FINANCIAL SUPPORT FOR MEXICO

Statement by

C. Fred Bergsten
Director
and
William R. Cline
Senior Fellow

Institute for International Economics

Before the
Committee on International Relations
US House of Representatives

February 1, 1995

On December 20, 1994, the new administration of Ernesto Zedillo devalued the Mexican peso by 14 percent from its rate of about 3.5 to the dollar, and almost immediately was forced to set the peso free to float. The cumulative depreciation reached about 35 percent by early January. On January 3 the Mexican government announced an economic adjustment program, supported by an $18 billion package of credit lines from the United States ($9 billion), Canada ($1 billion), Bank for International Settlements ($5 billion), and major private banks ($3 billion). In the second week of January there were pronounced runs on financial markets and currencies in a range of not only emerging market countries but also in some industrial countries (Canada, Italy, Sweden, and Spain). In face of the threat that the $18 billion package was insufficient and that a Mexican collapse could have international spillover, the Clinton administration and congressional leaders proposed a $40 billion program of US guarantees for Mexican government obligations. Soon after, the International Monetary Fund announced a $7.8 billion stand-by loan to Mexico.

The International Support Package

By the end of January, as the process of legislative approval of the US loan guarantee program had drawn on longer than expected, there were growing signs of financial market unraveling as the peso touched 7 to the dollar (a 50 percent cumulative depreciation) and the Mexican stock market fell further. There were also further declines in markets of other Latin American and Eastern European countries. On January 31 the Clinton administration responded by withdrawing the loan guarantee proposal and in its place announcing that US support through the Exchange Stabilization Fund and Federal Reserve swaps would be increased to $20 billion. Simultaneously, the International Monetary Fund announced that it would endeavor to mobilize $10 billion in support from non-BIS central banks (presumably including those of some East Asian and other countries holding large reserves). The IMF announced that to the extent that

the support so mobilized fell short of this target, it would increase its own stand-by loan above the original $7.8 billion level to make up the difference. For their part, BIS central banks increased the level of their support from $5 billion to $10 billion. By now there had also been announcement of $1 billion in support from Argentina, Brazil, Chile, and Colombia. The $3 billion from the banks was still part of the package, and investment banks were now to add another $1.5 billion. The total package thus amounted to at least $54 billion. This amount was comparable in magnitude to the original proposal.[1] In one important dimension, the new proposal was more favorable, because it was much more multilateral. In another dimension, however -- potential for long-term guarantee capacity -- it is unclear that the new proposal is comparable to the one that had been discussed with congressional leaders. The principal potential for the longer-term guarantees would seem to reside in the $20 billion US Exchange Stabilization Fund component, a more limited capacity than in the $40 billion guarantee proposal.

The package was large enough to deal with the two principal problems at hand: some $17 billion in short-term dollar-indexed government bonds payable in pesos (*tesebonos*) coming due in 1995, and a total of some $20 billion or so in dollar certificates of deposit and credit lines owed by Mexican banks.

The replacement package made a critical change in the use of the US Exchange Stabilization Fund's. Previously, this fund, which essentially holds US foreign reserves, had been activated only for short-term lending, of 3 to 6 months. The new proposal provided that the fund could be used to provide guarantees for maturities of up to 10 years. Essentially, the Exchange Stabilization Fund was thus replacing the legislated guarantee funds that would otherwise have been provided by the earlier guarantee proposal.

The unprecedented willingness to tie up a large portion of the Exchange Stabilization Fund's total resources (estimated at $25 billion to $40 billion, depending on inclusion of SDRs and other categories) reflected the urgency of the situation. It is reasonable to ask whether this decision reduces the US capacity to intervene in the exchange markets when needed (e.g. by purchasing dollars with DM or yen reserves). The answer is in the negative. The US government as a whole would not lose its holdings of foreign currencies because of the new proposal, although there would be bookkeeping transactions involving shifts of these currencies to

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[1] The earlier proposal would have meant $40 billion in US loan guarantees, $7.8 billion from the IMF, and the other components of the initial $18 billion package either including or excluding the $9 billion US component, depending on whether the guarantees were seen as a substitute. The earlier total was thus either $57 billion or $66 billion.

the Federal Reserve in return for dollars then usable by the Exchange Stabilization Fund for support to Mexico. If needed in the future, the Fed could make them available to the fund again on a swap basis. Moreover, the United States has huge swap arrangements with other G-10 central banks that assure availability of currencies for intervention if needed.

This testimony seeks to review the principal issues that emerged in the debate on the loan guarantee proposal. If the new alternative package proves to have limitations (for example, because of the short-term nature of the BIS funds and on the portion of the Exchange Stabilization Fund resources that can comfortably be used for longer terms), it might be necessary to reopen the guarantee initiative at some point in the future.

Causes

The underlying cause of the peso crisis was that Mexico had allowed the current account deficit to get too large: $28 billion in 1994, or 8 percent of GDP and more than 50 percent of exports of goods and non-factor services. The largest sustained deficits in the past three decades have been in the range of only 20 to 30 percent of exports (e.g. in Australia, New Zealand, Thailand, and -- until the mid-1970s -- Korea). The proximate trigger for devaluation was that reserves had fallen to only about $6 billion, a precariously low level of less than 10 percent of imports of goods and services.

Mexico had deservedly earned the reputation for excellent economic management in emerging from the debt crisis of the 1980s. What went wrong? The central mistake was excessive use of the nearly-fixed exchange rate as an "anchor" for the purpose of reducing domestic inflation, rather than a more balanced policy permitting a somewhat faster glide in the rate to ensure that Mexico's exports remained competitive and imports were not unsustainably cheap. The strategy succeeded dramatically in reducing inflation (from over 150 percent in 1987 to single digits), but at the cost of growing overvaluation of the peso.

Despite the recent Monday-morning quarterbacking, at least through early 1994 there was a case that the model would work. Reserves were still rising through February of 1994 without requiring high domestic interest rates, evidence that the driving force was foreign capital eager to enter rather than Mexican policy causing an excessive thirst for this capital. Indeed, much of the current account deficit in 1991-93 had been financed by the repatriation of a sizeable portion of the flight capital of some $90 billion that had been built up by private citizens in the 1980s, and so did not impose the kind of future burden that would have been implied if the deficit had been financed by a buildup of foreign debt.

There was even a popular theory, espoused by former UK Chancellor Nigel Lawson, that held that so long as the government did not have a budgetary deficit, the foreign current account deficit was not a problem. The theory maintained that in that case, private investment was financing the deficit, and if private capital flows declined, there would be a prompt reduction in imports of capital equipment. Mexico's finance minister, Guillermo Ortiz, has pointed out that even the IMF and World Bank were supporting the Mexican strategy. For the strategy to have worked, of course, the large trade deficit would have to have translated into capital investment that set the stage for subsequent rapid growth in Mexico's exports, so that the gap could be self-moderating over time. By 1993 there were some signs that this process was in place, as exports grew faster (at 8.2 percent) than imports (0.3 percent). However, in 1994, with the influence of NAFTA liberalization and reaccleration of the economy, imports grew more rapidly than exports once again (15.4 percent versus 11.6 percent, based on data for the first six months).

Despite the 1994 trade trends, it is conceivable the strategy would have worked if it had not been for three things: rebellion in Chiapas, the assassination of presidential candidate Luis Donaldo Colosio, and (though to a lesser degree) the increase in US interest rates beginning in February of 1994. In retrospect, by March of 1994 after the Colosio assassination caused sharp pressure on domestic interest rates (figure 1) and reserves, the Mexican government should have accelerated the crawl of its exchange rate and carefully husbanded its stock of almost $30 billion then held in reserves. Instead, because the government feared that any move toward faster devaluation would simply translate into higher inflation rather than improved competitiveness, it liberally used reserves in an effort to hold the exchange rate. The reserves dropped by about half by April. Then they remained almost flat through November. It was not a wholly unrealistic hope of the central bank and government that reserves would rebuild after the election and installation of the new president restored political certainty. Then in early December a sharp escalation of the Chiapas revolt, and increasing expectations that the end of the political term (*sexenio*) might see a devaluation as on some occasions in the past, caused a sudden further drop in reserves.

The Guarantee Proposal

The principal problem driving the peso collapse by early 1995 was the fact that some $17 billion in foreign-held *tesebonos* were coming due this year, but in view of the low level of reserves, financial markets were fearful that holders would attempt to convert the pesos paid in principal into dollars, and that without enough dollars in reserves to cover these maturities, the Mexican government would be forced to unilaterally reschedule the bonds at longer maturities. The US guarantee program amounted to financial insurance that would provide the confidence to investors to

purchase replacement, longer-term bonds from the Mexican government rather than seek to withdraw their money as *tesebonos* came due. The program would have charged an up-front fee commensurate with a country-risk spread of 2 percent annually (the rate on Mexican bonds in 1993). In addition, there would have been a pledge that in the event of a default, Mexico's oil company PEMEX would instruct its foreign customers to make payments for oil to banks representing the US Federal Reserve, a quasi-guarantee based on Mexico's oil earnings of about $7 billion annually.

Mexico's problem is a classic example of temporary illiquidity rather than long-term insolvency. Mexico today has a far stronger economy than in 1982 when the country ignited the international debt crisis. The government has carried out dramatic fiscal reform (figure 2). External debt indicators are far more favorable than in the early 1980s (figure 3). Public debt (including foreign debt of about $75 billion, plus $28 billion in peso-payable *tesebonos* as well as about $8 billion equivalent in *cetes*, treasury bills), amounts to some $115 billion, or only about 40 percent of GDP -- considerably below the level of most OECD countries.

Because Mexico's underlying solvency is strong, there is little risk that US loan guarantees would have been activated by a default. As a result, the "insurance" fees payable on the guarantees would have been a likely profit for the US fiscal accounts, on the order of $5 billion. The guarantees would have had the strong favorable effect for Mexico of enabling the government to reduce interest rates on peso debt from their recent crisis levels (25 percent even on dollar-indexed *tesebonos*, and nearly 40 percent on *cetes*). Lowering these interest rates is crucial, because otherwise Mexico's domestic debt will snowball. Moreover, high interest rates tend to bring severe problems in the banking sector, as banks suddenly have to pay much higher rates on deposits than they receive on outstanding loans, and as their client firms enter payments difficulties. Although the alternative package announced on January 31, 1995 should permit substantial reduction in Mexican interest rates, because the package does not have as large a scope for guaranteeing long-term maturities, its potential for reducing Mexican interest rates could be somewhat weaker.

Risks of Inaction

In the absence of US (and international) support, either through the loan guarantee program, the subsequent alternative package, or at the minimum, the original $18 billion program, there were serious risks of economic dislocation in Mexico, the United States, and internationally. One scenario would have been that the Mexican government would be forced to unilaterally announce that the *tesebono* maturities had been postponed by, say, 10 years. In the debt crisis of the 1980s, that was essentially what happened. Banks rescheduled their loans on longer terms, and in addition lent

some new money to help pay part of interest. This time, however, the creditors are myriad small investors and mutual funds. It would be much more difficult to orchestrate some type of concerted lending from them. Yet resorting to unilateral postponement would have had a devastating effect on Mexico's ability to borrow on the international bond markets in the future.

An alternative scenario might have involved Mexico's simply paying off the *tesebonos* in pesos, allowing the exchange rate to move even more sharply. The cost to Mexico would have been even more punishing inflationary consequences, especially hard on the poor. Still another alternative could have been to pay off the bonds but institute exchange controls (for example, setting one rate for capital transactions and another for trade). That alternative would have raised all the familiar problems of exchange controls, traditionally considered ineffective in Mexico because of the long border with the United States.

As noted, in any of these scenarios, another risk to the Mexican economy was that with high domestic peso interest rates necessary without the financial package, some Mexican banks could increasingly be pushed toward bankruptcies.

These scenarios would have carried heavy economic penalties for both Mexico and the United States. Even in the best case, with effective implementation of Mexico's adjustment program -- which cuts the current account deficit from $28 billion to $14 billion -- the reduction in the US trade balance with Mexico (goods and services) will probably be on the order of $10 billion, considering that the United States accounts for about 80 percent or more of Mexico's trade. Without a financial package, Mexico's adjustment would have to be much more sudden and wrenching, conceivably twice as large. The Council of Economic Advisors has estimated that there are some 700,000 US jobs associated with the base of about $50 billion in exports of goods and services to Mexico. So even in the best case, about 140,000 jobs can be expected to be lost in the near term. Without a financial package, this loss could double to 280,000 jobs.

In addition, without a financial package it is highly likely that Mexico's economy would undergo a severe recession, instead of a slowdown of growth to the range of 1 percent or so. Without support, Mexico's peso depreciation and domestic inflation would both probably be higher than otherwise necessary. So would the resulting decline in real wages. The combination of recession and sharply falling real wages would have been likely to increase illegal immigration from Mexico into the United States. This effect has been estimated within a wide range of fewer than 100,000 to as high as 500,000 additional migrants. Even the lower range would be a major burden for US border states.

Beyond the impact of inaction on the Mexican and US economies, there is considerable risk that international financial spillover would cause instability and a slowdown of growth in the world economy. On strictly rational grounds, the extent of this spillover might be limited. Indeed, countries such as Chile and Colombia have complained of too much capital inflow, rather than too little. Superficially, the major country vulnerable to a spillover effect might be thought to be Argentina, because it is the only other prime case with a large current account deficit and a fixed exchange-rate "anchor." A closer analysis suggests that Argentina is in fact much more resilient than the Mexican case. Its current account deficit is only about one-third as large relative to GDP. Its reserves are high. Its currency board system precludes a rapid rundown in reserves without a corresponding reduction in the money supply, which would induce higher interest rates, price restraint, and other partly corrective mechanisms. Importantly, Argentina already stretched out its domestic short-term debt in the Bonex plan of 1989, so it does not have large amounts coming due posing exchange market pressure.

However, financial markets are often less than fully rational, and are subject to herd behavior and mood swings. Especially in the new structure of the capital market, whereby developing countries are receiving capital from individual investors and mutual funds rather than from syndicated bank loans, there is a risk that the psychological impact of a Mexican financial collapse could be a generalized capital exodus from these countries. Certainly the initial indications have shown nervous exchange and stock markets in a long list of countries, even including such industrial nations as Canada, Italy, Sweden, and Spain. In short, in these uncharted waters, there is some risk of systemic spillover from Mexico.

The third fundamental risk of inaction was the undermining of the central model of economic development that had come to dominate in the last decade, and had been closely associated with the Mexican example. This model involved massive correction of fiscal imbalances, sharp reduction in import protection, sweeping privatization of state enterprises, and deregulation of the economy. The model has been largely adopted in Latin America, and has contributed much to the turnaround in economies in the region. Mexico's mistake lies in one component of implementation of the market-oriented model: choice of an exchange rate anchor. Yet unraveling of the Mexican success could bring a retrogression in economic reforms associated with the Mexican model, back toward greater state intervention, closed markets, and populist budgetary excesses.

Arguments Against the Guarantees

Despite the urgency of action, there were numerous objections raised to the guarantee program.

Let the Market Do It -- At the most general level, it was argued that the US government should not intervene; the market should work out the problem. If this argument had been rigidly adhered to in 1982, it is likely that there would have been a banking crisis in the largest US banks. It should be kept in mind that in that crisis, at the outset for Mexico alone the United States government mobilized $1 billion in commodity credits, $1 billion in advance purchases for the strategic oil reserve, and $1 billion in Federal Reserve swaps. In addition, there was IMF support of $3.7 billion, BIS support of $1 billion, and support from export credit agencies of industrial countries amounting to $2 billion (Cline, 1984).

At least two market failures can justify government action in such circumstances: the "external diseconomy" whereby one creditor withdrawing imposes higher risk on other creditors (and its corresponding "free rider problem" of mobilizing credit); and the "credit rationing" problem (Stiglitz and Weiss, 1981), whereby even a creditworthy borrower with a liquidity problem cannot mobilize new loans by raising the interest rate because a sharply higher interest rate becomes interpreted as a sign of desperation and unreliability. More concretely, when investors learned that Mexico's reserves had dropped to only $6 billion, and they compared this figure to the $17 billion in dollar-indexed *tesebonos* coming due, they feared a liquidity crunch that could cause capital controls or unilateral bond stretchout even if Mexico was solvent from a longer-term standpoint.

Mexico's Structural Flaws -- Another argument was that it would be a mistake to guarantee bonds issued by Mexico without first correcting structural flaws in the economy. These flaws supposedly included excessive taxes, wage-price controls, and a need to shift to a currency board monetary system. The currency board idea is discussed below. However, it is difficult to argue that a marginal tax of 35 percent is oppressive when the United States has similar marginal tax rates. Moreover, a major reduction in taxes would almost certainly reduce revenue, introduce a fiscal deficit, and widen rather than narrow the external current account gap.

It would also be a mistake to ignore the key role that the Solidarity Pact (*Pacto*) agreements between the government, labor, and business have played in economic stabilization in the past. The dramatic reduction of inflation after 1987 would not have been possible without these agreements, and in the specific political and cultural conditions of the Mexican case, the Pacto approach holds merit. In particular, it is likely to play a crucial role in preventing the recent sharp devaluation of the peso from translating into high inflation (as the present Pacto limits government and collective bargaining wage increases to 7 percent).

The main point is that far from being structurally flawed, the Mexican economic strategy was excellent in almost all areas except for the exchange rate strategy. It is true that another problem

that emerged in 1994 was a rapid buildup in loans through the government development banks, which reached some 4 percent of GDP. But it is questionable for US observers to charge structural mismanagement of the Mexican economy when that country has carried out the equivalent of a five-fold Gramm-Rudman-Hollings budget reform, whereas it has proven elusive to achieve even one-fold in the United States.

Adopt a Currency Board -- Apparently because of the success of Argentina, there has been a surprisingly strong current of arguments to the effect that Mexico should adopt a currency board as a precondition for guarantee support. A currency board is an extreme measure, and after hyperinflation of 3,000 percent in 1989 in Argentina, extreme measures were not only called for but possible. In particular, hyperinflation had so reduced people's willingness to hold money that the domestic currency money supply was of comparable size to dollar reserve holdings and it was feasible simply to decree that every Argentine peso had to be backed by a dollar. In contrast, Mexico now holds $6 billion in reserves but has about $40 billion in peso money supply (M1).

Does the United States really want Mexico on a currency board regime? This system is really a gold standard mechanism. If reserves flow out, domestic money supply falls. If prices do not fall, the result is severe recession. That feature is what caused the demise of the gold standard in most countries at the beginning of this century. It is far from clear that it is to the US interest to have on its border a country committed to severe recession as the form of economic adjustment.

The more fundamental point, however, is that the people best positioned to judge whether Mexico should adopt a currency board are the Mexican leaders and experts themselves, not outsiders. It would be a mistake to impose this system as a precondition for external support.

Why Reward the Big Banks and Wall Street? -- In the debt crisis of the 1980s, Congress was particularly sensitive to the equity issues of responsibility for the debt problem. At the end of the day, it turned out that the banks accepted a reduction of claims equivalent to about 35 percent. That means that they bore the burden of excessive lending about equally with the debtors in the Brady Plan, if it is assumed that the excess in that round of lending was no more than two-thirds of the bank debt (that is, the country's adjustment absorbed one-third, the bank forgiveness one-third, and the other third was not excessive lending).

This time around, the commercial banks are essentially irrelevant to the problem. It would be difficult to force them to accept a loss even if that were considered fair, because they converted their long-term claims on Mexico in 1990 into collateralized bonds that automatically begin making payments out

of escrow accounts if Mexico does not service the bonds on a timely basis. There is of course the additional question of why it would be appropriate to ask the banks to accept a further hit when they have already forgiven 35 percent, and when they were largely absent in the 1991-94 capital flows.

In the new round of capital inflows, it has been mutual funds and private investors that have purchased Mexican stocks and bonds. It is simply unknown whether the composition of these investors is overwhelmingly rich individuals or instead primarily average households who may not even know that their pension funds hold these assets. The chances are, however, that a fairly wide spectrum of Americans would be hurt if there were a major loss on *tesebono* claims. As for "Wall Street," the fact is that the large brokerage houses primarily act as intermediaries for the investors. They no doubt hold some bond inventories, but even inflicting large losses on these holdings would provide only minuscule relief to Mexico. On the contrary, that approach would be almost certain

An important aspect of this equity concern was that investors that had placed their money in *cetes* or in Mexican stocks had already taken a large hit from the devaluation of some 35 percent. To some extent this loss had a built-in equity, because these investors had enjoyed prior gains from high peso interest rates that had incorporated exchange rate risk. Thus, an investor who bought *cetes* in early 1990 would have earned a cumulative 55 percent in dollar terms through early December, 1994, compared with only 18 percent if they had invested in US treasury bills.

In contrast, holders of *tesebonos* had not enjoyed these outsized profits. As may be seen in figure 1, interest on these dollar-indexed bonds had been far lower than the unindexed *cetes* rates. So from this standpoint, it is not particularly equitable to insist that holders of *tesebonos* -- the principal problem -- should take a substantial loss.

More fundamentally, experience with the debt crisis of the 1980s showed that it makes more sense to adopt forward-looking policy rather than policy premised on somehow sharing the blame for the past. For example, Chile elected not to seek any forgiveness on debt because it was looking ahead to investment-grade credit status in international capital markets. Argentina settled for a 35 percent cut, even though at one point its secondary market price had been as low as 11 cents on the dollar, again because it had the future capital market to consider. Forcing losses on foreign holders of Mexico's domestic debt today would primarily have a counterproductive effect by jeopardizing normalization of Mexico's future access to bond markets.

Conditions on Support

Both the earlier loan guarantee proposal and the January 31 package incorporated conditionality on sound economic policy, principally through linkage to IMF endorsement of Mexican policy under the Fund's stand-by loan program. However, several additional conditions had been proposed from various quarters. *Restore the Peso to 3.5* -- One group insisted that the peso should be restored to a value of 3.5 to the dollar as a condition for support. There seemed to be two motives for this suggestion. The first was the idea that in this way Mexico would not obtain a new competitive advantage against US exporters. The second was the notion that devaluation does not work and therefore Mexico's devaluation should be reversed. The two ideas are to some extent contradictory, because if devaluation does not work there is no need to fear increased Mexican competitiveness from devaluation.

The reality, however, is that Mexico needed to carry out a real devaluation, precisely because it needed to improve its competitiveness. Its trade deficit was too large to be sustainable. The alternative to correction through devaluation would probably have been some form of import restrictions, rather than any automatic drop in Mexican peso prices to achieve a gold-standard-like trade balance correction without a change in the exchange rate.

As for the argument that there is no real devaluation when the nominal exchange rate is changed, because of induced offsetting inflation, that problem is of course a risk, and was one of the reasons the Mexicans tried so long to avoid devaluation. However, the Pacto wage ceiling holds considerable promise that the induced Mexican inflation will not be fully or even largely offsetting to the devaluation. In any event, when the reserves ran out, so did the option of holding the rate fixed at 3.5 to the dollar.

Revise Mexican Labor Laws and Oil Policy -- Another genre of conditions would require that Mexico must change some of its basic internal laws to qualify for support. One suggested area has been to change labor legislation to strengthen unions, or sharply raise the minimum wage, or require an increase in wages commensurate with productivity gains, or otherwise. Another area has been the proposal that Mexico's constitutional nationalization of the oil industry be reversed.

The strong likelihood is that anything other than vague requirements along these lines would precipitate outright Mexican rejection of external support. There has already been domestic reaction in Mexico to such proposals as invasive of the country's sovereignty. US insistence on such basic changes in internal institutions, going far beyond what was agreed in NAFTA, could poison the US relationship with its free-trade partner for years to come. The linkage of support to the quasi-guarantees from oil

already goes some way in this direction and is probably all that Mexican political reaction would tolerate. Moreover, in some formulations the proposals would simply not make sense. In particular, it would be infeasible to require that Mexico's minimum wage be set at a US level. Mexican wages are lower than those in the United States because Mexico's productive capacity per worker is lower, and this difference cannot be legislated away.

Make the Central Bank Independent -- Actually, Mexico's economic reforms have already included a substantial move toward independence for the central bank. Indeed, it seems likely that much of the resistance to an earlier shift to devaluation and defense of Mexico's reserves came from the central bank, which has been known to favor a strong peso.

Historical Lessons

In a forthcoming study, Cline (1995) reexamines the debt crisis of the 1980s. It is appropriate to consider the lessons from that experience that might be applicable to the present problem.

Forceful International Action -- The experience of the 1980s demonstrated that decisive and forceful international action could successfully control what could otherwise devolve into a systemic crisis. In 1982 the US Federal Reserve, Treasury, and the International Monetary Fund acted decisively to arrange international packages that prevented defaults that could have caused insolvency of major industrial country banks. At successive stages in management of the debt crisis, there were new phases of international action to deal with the new situations (in particular, the worsening of the problem after the collapse of oil prices and the corresponding blow to key debtors including Mexico and Venezuela). The eventual solution of the Brady Plan successfully restored most debtor countries to capital market access, and required international cooperation ("enhancement" resources from the IMF, World Bank, IDB, and Japanese government) to implement. In this regard, the January 31 package is promising because it has the features of decisive action internationally coordinated.

Banks versus Individual Investors -- As noted, one of the legacies of the 1980s experience is that syndicated bank loans were largely absent in the new round of capital flows in the 1990s. Instead, individual investors and mutual funds were dominant (along with a major revival of direct foreign investment). A concern about this transformation was that it would be more difficult to orchestrate debt rollovers in any future crisis, because it would no longer be possible to deal with the problem through a group lead by a few large banks. This challenge has now come to pass in the Mexican case. The vehicle of the loan guarantee makes eminent sense as the way to deal with this new problem.

One implication of the transformation in the creditor structure is that the 1995 peso crisis is a less direct threat to the international financial system than was the debt crisis of 1982. This time there is no direct jeopardy of the banking systems of the industrial countries. Nonetheless, systemic risk is present in the sense that a generalized flight from capital flows to emerging market countries, precipitated primarily for psychological reasons in reaction to an unresolved Mexico crisis, could cause recessions in these countries and a slowdown in world economic activity.

Illiquidity versus Insolvency -- The experience of the 1980s shows that at the end of the day, there were major cases of debt crises where the countries were illiquid rather than insolvent. Thus, such countries as Korea, Indonesia, Chile, and Colombia were able to manage their debt without eventual partial forgiveness, even though they were among the countries of great concern at the outset. Arguably Mexico could have avoided insolvency (debt forgiveness) if the price of oil had not collapsed, considering that its relief on debt was smaller than its losses on oil.

The importance of relending principal when the problem is one of illiquidity rather than insolvency is particularly relevant to the present Mexican crisis. In essence, the peso crisis is a currency crisis perhaps more than a debt crisis. As such, it resembles the problem of the Italian lira in 1992 more than that of Mexican debt in 1982. As noted above, the relative debt levels and fiscal balance of Mexico are far improved from the 1982 levels. Accordingly, it is appropriate to emphasize mechanisms that mobilize liquidity for Mexico. Such mechanisms will avoid unnecessary default. They will not be throwing good money after bad money, because the past money is not bad.

Domestic Economic Reform is Crucial -- One of the strongest lessons of the 1980s debt crisis was that domestic economic reform mattered more than international economic conditions in determining which countries emerged the earliest from the debt problem. In this regard, Mexico today stands in excellent shape to weather the peso crisis, precisely because the nation has systematically adopted the economic reforms that provide the fundamental underpinning for stable growth in the future. With the coming to grips with the exchange rate overvaluation problem, Mexico now is in a position to correct the one major area where policy had gambled and lost. Now the crucial challenge is to ensure that domestic inflation does not surge and neutralize the real effects of the devaluation. That is one reason that IMF and US policy monitoring in such areas as credit expansion will be important, as will Mexico's success in keeping the Pacto wage agreements on track.

Market-related Measures Work Best -- The eventual resolution of the 1980s debt crisis involved Brady Plan workouts that were

market-oriented in design, and involved a degree of voluntariness. They were voluntary to the extent that banks could choose the option of new money. They were market oriented in the sense that they set the depth of cut for the debt at levels that took account of the secondary market prices on the one hand and the extent of collateral provided on the other. There are strong reasons to believe that this market orientation was an important reason that other capital market actors were prepared to provide new credit to these countries in the 1990s. More extreme and unilateral solutions would have been much more likely to choke off a return to the capital markets, just as the more confrontational defaults of the 1930s contributed to a locking out of most Latin American countries from the capital markets for 40 years (or 25 years, depending on whether time out is taken for World War II and its aftermath).

This experience suggests it is extremely important to assure that the Mexican peso crisis is dealt with in a way that involves the maximum degree of voluntariness and market orientation. If Mexico were forced into a more unilateral posture involving the forcing of postponement of maturities upon creditors, the financial atmosphere for Mexico's access to credit markets would be polluted for some time to come. Fortunately, the international package announced on January 31 should make it possible to avoid this outcome.

Politics Affect Creditworthiness -- Another lesson from the debt crisis of the 1980s is that political perceptions play a large role in debt dynamics. Creditworthiness is influenced not only by ability to pay but also willingness to pay. This helps explain how the Brady Plan had such dramatic effects even though the direct debt service savings were limited. That Plan cleared the air of the debtor political perception that burden-sharing had been inequitable previously in the debt crisis.

Applied to the Mexican peso crisis, the political dimension suggests important admonitions. One is that it would be a serious mistake to attach invasive political conditions that would be seen in Mexico as violating sovereignty. Such conditions as the price of support could begin to push Mexico into an unnecessary position of unilateralism in treatment of the *tesebonos* and other relevant debts. In another dimension, the political perspective suggests that multilateralism in the January 31 package is preferable to the US dominance of the earlier loan guarantee proposal. The reason is that if Mexico's obligations came to be seen as owed heavily to the US government, there could eventually be pressure for special treatment analogous to the 50-percent forgiveness of US government claims given largely on political grounds to Poland and Egypt in 1990.

Confidence Has a High Value -- The salient pattern of economic response to the Brady Plan was one of sharply reduced country-risk

premiums in the interest rates in the countries in question. In Mexico itself, domestic interest rates fell from 55 percent annually in June of 1989 before the Brady agreement in principle to 35 percent in August after that agreement, and to even lower levels by mid-1990 after the finalization of the agreement. Confidence that principal bunchings would be smoothed was critical to this reduction (Claessens, Oks, and Van Wijnbergen, 1993). Similarly, the country-risk spread dropped sharply for Argentina after its Brady arrangement. Lower real domestic interest rates were crucial to revival of investment and growth. In the case of Mexico in 1995, assurance of the smoothing of refinancing of maturities coming due should similarly provide the key ingredient for reducing domestic interest rates from stratospheric levels.

Conclusion

We applaud the package of international support announced on January 31, 1995. We consider that it would have been desirable for Congress to adopt the earlier loan-guarantee proposal, because that proposal had the potential to solve Mexico's liquidity problem at minimal budgetary cost to the United States (and probably a sizeable profit). However, the new package is a good substitute, and has the strong added advantage of being much more multilateral.

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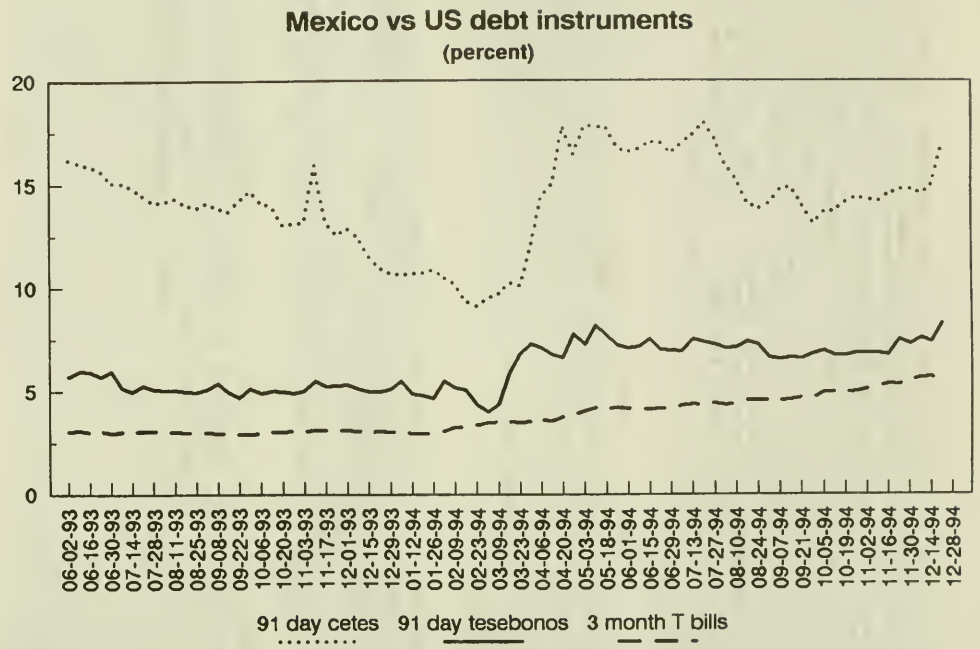
Figure 1


Mexico vs US debt instruments
(percent)
20
15
10
5
0
06-02-93
06-16-93
06-30-93
07-14-93
07-28-93
08-11-93
08-25-93
09-08-93
09-22-93
10-06-93
10-20-93
11-03-93
11-17-93
12-01-93
12-15-93
12-29-93
01-12-94
01-26-94
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07-27-94
08-10-94
08-24-94
09-07-94
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10-19-94
11-02-94
11-16-94
11-30-94
12-14-94
12-28-94
91 day cetes
91 day tesebonos
3 month T bills

Figure 2

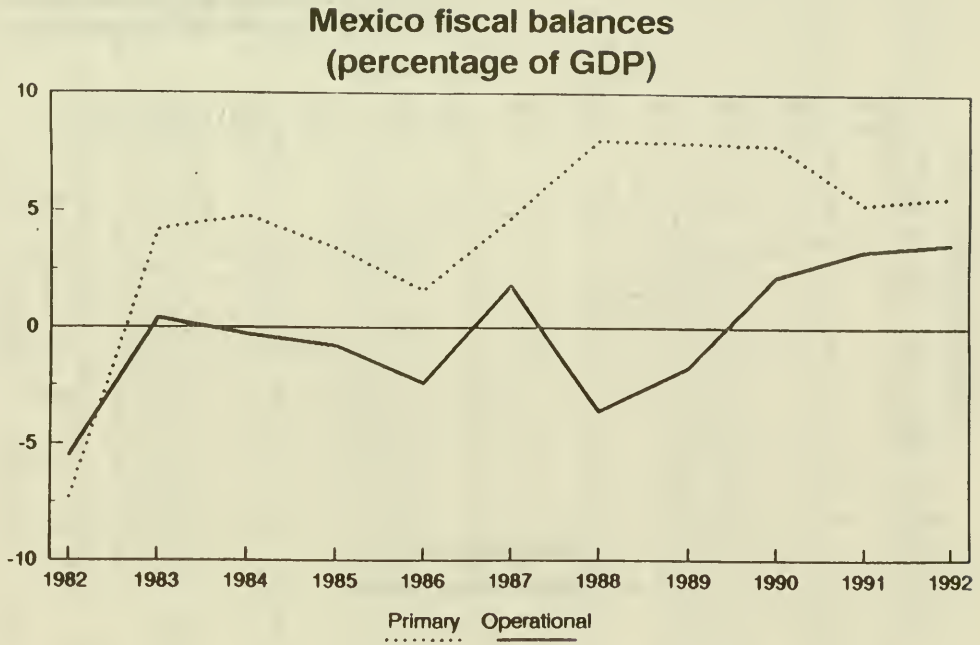
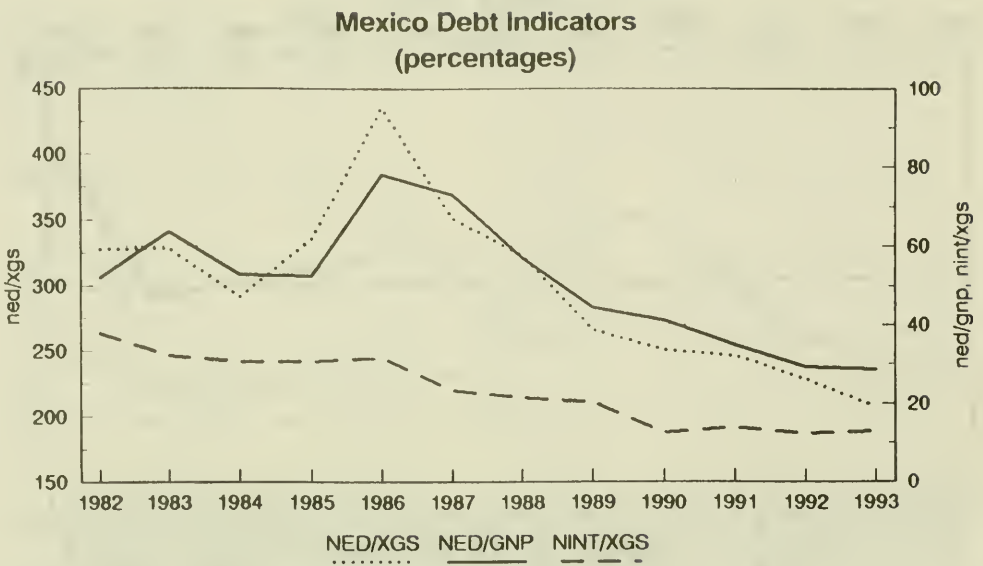

Mexico fiscal balances
(percentage of GDP)
10
5
0
-5
-10
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
Primary
Operational

Figure 3



ned/xgs-net debt over exports of goods+services
ned/gnp-net debt over gross national product
nint/xgs-net interest payments over XGS

C. FRED BERGSTEN
Suggested Introduction Material

1. C. Fred Bergsten has been Director of the Institute for International Economics since its creation in 1981. The Institute is the only major research institution in the United States devoted to international economic issues.

2. Dr. Bergsten is the representative of the United States on, and Chairman of, the Eminent Persons Group created in 1992 by the Asia Pacific Economic Cooperation organization (APEC). The Group is advising the 18 member governments on future directions for Pacific Basin economic relations.

3. Dr. Bergsten is the Chairman of the Competitiveness Policy Council created by the Congress in the Omnibus Trade and Competitiveness Act of 1988. The bipartisan Council has twelve members equally chosen from business, government, labor and "the public"--four each appointed by the President, Senate and House. Four reports on improving the competitiveness of the American economy have been presented to the President and Congress (March 1992, March 1993, October 1993 and May 1994).

4. Dr. Bergsten was Assistant Secretary of the Treasury for International Affairs during 1977-81 and also functioned as Under Secretary for Monetary Affairs during 1980-81.

5. During 1969-71, Dr. Bergsten served as Assistant for International Economic Affairs to Dr. Henry Kissinger at the National Security Council.

6. Dr. Bergsten has been a Senior Fellow at the Brookings Institution (1972-76), Carnegie Endowment for International Peace (1981) and Council on Foreign Relations (1967-68).

7. He has authored twenty-two books on international economic issues including *Reconcilable Differences? United States-Japan Economic Conflict* (1993); *Pacific Dynamism and the International Economic System* (1993); *America in the World Economy: A Strategy for the 1990s* (1988); *Trade Policy in the 1980s* (1982); *American Multinationals and American Interests* (1978); and *The Dilemmas of the Dollar: The Economics and Politics of US International Monetary Policy* (1976).

8. Dr. Bergsten is a member of the Executive Committees of the Trilateral Commission and the Bretton Woods Committee, and is a member of the Council on Foreign Relations.

9. Dr. Bergsten has recently been a member of the National Academies of Science Panel on The Government Role in Civilian Technology, the Defense Science Board Task Force on Foreign Ownership and Control of U.S. Industry, the Carnegie Endowment National Commission on America and the New World Order, and the Commission on Government Renewal sponsored jointly by the Carnegie Endowment and the Institute for International Economics .

10. Dr. Bergsten testifies frequently before Congressional committees and appears often on television news programs. He is quoted widely in the quality press and is a popular public speaker.

11. Dr. Bergsten has received the Exceptional Service Award of the Treasury Department, the Meritorious Honor Award of the Department of State and the Legion d'Honneur from the French Government.

12. Dr. Bergsten received M.A., M.A.L.D. and Ph.D. degrees at the Fletcher School of Law and Diplomacy. He received his A.B. *magna cum laude* and an honorary Doctor of Humane Letters from Central Methodist College in Missouri.

Testimony to the Committee on International Relations

Statement of M. Delal Baer, Senior Fellow and Director
Center for Strategic and International Studies

February 1, 1995

Conditionality and U.S. Foreign Policy

The aftermath of the Mexican loan guarantee crisis presents a good opportunity to reflect on the merits of cross-issue linkage and conditionality as a tool of foreign economic and diplomatic policy, particularly as it plays out in congressional deliberations. The Mexican loan guarantee package failed for many reasons, but the paralysis induced by piling on extraneous, non-financial conditions was one key factor.

Common sense suggests that it is impossible to achieve all of our foreign policy objectives at the same time or in one piece of legislation. This is particularly true of the complex U.S.-Mexico bilateral agenda. How can we do justice to thorny issues like immigration and prisoner exchange by tacking them on to a financial crisis? When we try to link every issue, we end up solving none.

This is not a trivial procedural issue. In the case of Mexico, congressional conditionality threatened to cripple our ability as a nation to conduct a credible foreign policy. Other nations watched the fiasco and wondered, "if the U.S. cannot act when a crisis threatens Mexico on its southern border, when will it act?" Conditionality became, for some, a pretext to avoid tough decisions. The free-for-all over Mexico set precedents that weaken the institution of the presidency and tie the hands of future presidents, both Republican and Democrat.

Looking over the horizon, the renewal of fast track authority to negotiate a free trade agreement with Chile is the next test of our resolve. Will it bog down in another tangle of conditionality? At what point will our future economic partners shy away from such wrangling?

U.S. Relations with Mexico: What is at Stake?

Many observers of Mexico worry that the loan guarantee debacle has done damage to bilateral harmony that will take some time to mend.

For a while, it almost seemed the U.S. would stabilize Mexico financially and destabilize it politically. The government of President Ernesto Zedillo was in an impossible position-- every step taken toward accommodating Congress brought Zedillo one step closer to the political abyss at home. Appeasing congressional

conditions in the U.S. turned up nationalist heat in Mexico. Americans seemed oblivious to the fact that they were asking a fragile Mexican government to commit political suicide.

Conditionality pushes Mexico's cultural, political and historical buttons. Mexico has long been characterized by unusual sensitivity to real and perceived intrusions on its national sovereignty. It is a nation scarred by the historical traumas of the Spanish conquest, the Mexican-American war, and numerous other foreign interventions.

Still, the U.S. and Mexico made an enormous effort over the past 12 years to overcome history and to edge toward real trust. This progress culminated in NAFTA. The rapprochement served as a model in every country in Latin America.

But the bonds of this new friendship are fragile. The failure of the loan guarantee package is a rebuff. Expectations were first raised, then dashed. The political conditions to the package were viewed as a demeaning and egregious intrusion into sovereign affairs. The tone of the debate turned ugly. One poll by the Mori firm holds that 62 percent of Mexicans believe the U.S. package would compromise sovereignty.

Put simply, the U.S. needs to handle bilateral relations carefully-- not because we are nice guys, but because we need a good, working relationship with Mexico to address problems that we can not solve alone. It is counterproductive to behave as if we have forcibly extracted the cooperation that Mexico offers up willingly out of good will. Even the friendliest Mexican government will feel compelled to distance itself from the U.S.

Mexican Political Developments

These dynamics are especially acute given that Mexico is recovering from 2 political assassinations, guerrillas and a heated presidential election in 1994. The U.S. should not take stability for granted in an age when Zhirinovsky-style demagogues and hypernationalists populate the post Cold War landscape. Mexico's financial crisis easily could have turned into a national security crisis were it to linger for too long.

It is because developments in Mexico have such a direct impact for the U.S. that former American presidents, 6 former Secretaries of State, 5 former Secretaries of the Treasury, 6 former Secretaries of Commerce, 5 former U.S. Trade Representatives and numerous former high government officials and scholars supported expeditious action.

Mexico is in the midst of a transition to complete democracy, and its emerging democracy is as fragile as its emerging markets. Economic crisis has speeded political opening in unexpected ways.

President Zedillo no longer commands party discipline and the PRI is increasingly independent. If efforts to stabilize the economy waver, Zedillo could be challenged by a wing of the PRI and by opposition forces that are unfriendly to economic reform, wary of the U.S. and resistant to political opening. Populists, nationalists and authoritarians still abound, both within the PRI and without. They flourish in an environment of economic crisis.

The PRI at the state and local level has defied presidential wishes that the PRI-elect governor of the state of Tabasco resign, putting in jeopardy a national political accord to advance democracy. Zedillo could face resistance from senior PRI leadership to opposition electoral advances as the year progresses, and a Mexican president weakened by persistent financial crisis would be less able to keep the political opening on track.

The PRI's new independence together with invigorated opposition parties means a more feisty Congress. Priistas concerned about the conditionality in the loan guarantee package voted with opposition members to require congressional oversight before the package was approved.

Zedillo faces a paradox. Mexicans and Americans have long complained loudly of insufficient democratization in Mexico. Now that we are seeing more democracy in Mexico, those same voices complain that Zedillo is a weak president. Americans don't understand why Zedillo cannot simply issue decrees to further economic reform. Zedillo is a struggling democrat (with a small d) who needs a little patient understanding and some very rapid economic action.

Mexico's Market Economic Revolution

Mexico's financial crisis has given new life to those who never believed in market economic reform. The sooner that Mexico returns to growth, the sooner those voices will be stilled. A critique is needed, but not one that throws the baby out with the bathwater.

Mexico was the birthplace of the first social revolution of the 20th century, predating the Soviets. Mexico has always been a trend leader, first in social revolution and then in post-Cold War market revolution. Many in the U.S. believe that Mexico's market reform has not gone far enough, but many in Mexico remain attached to the mythology of the Revolution. It is as difficult for Mexico to privatize PEMEX as it is for the U.S. to privatize social security, although both should be done. The pain of economic correction must be limited as soon as possible, lest the paradigm be shaken.

Finally, rapid economic stabilization is key to social stability. The media spin of the Chiapas guerrillas is greater than their military reach. They do not appear to have a capability in other states. Still, pockets of misery throughout Mexico are fertile terrain for political anger. Guerrilla leader Marcos may be tempted to take advantage of a weakened economy and a weakened president.

In sum, there is no better antidote to social instability than economic growth. There is no better underpinning to a stable democracy than financial stability. And there is no nation in the world where the resolution of these issues are more important to the United States than in Mexico.

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Jeff Faux is president of the Economic Policy Institute (EPI), a Washington, D.C., think tank. Since its inception in 1985, EPI has become the primary national source of independent analysis that evaluates economic trends from the perspective of people who work for a living.

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